THE ADMINISTRATION'S PROGRAM TO ENHANCE CREDIT AVAILABILITY

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HEARING

BEFORE THE

COMMITTEE ON SMALL BUSINESS
HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRD CONGRESS

FIRST SESSION

WASHINGTON, DC, JUNE 16, 1993

Printed for the use of the Committee on Small Business

Serial No. 103-45

FEB 15 1994

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THE ADMINISTRATION'S PROGRAM TO ENHANCE CREDIT AVAILABILITY

WEDNESDAY, JUNE 16, 1993

House of Representatives,
Committee on Small Business,
Washington, DC.

The committee met, pursuant to notice, at 10:20 a.m., in room 2359-A, Rayburn House Office Building, Hon. John J. LaFalce (chairman of the committee) presiding.

Chairman LaFalce. The Small Business Committee will come to order.

Before we open our proceedings this morning, I would like to call on the ranking minority member, Mrs. Meyers, for the introduction of a new member.

Mrs. Meyers. Yes; I would like to introduce Rob Portman, from Ohio, who is a new member of the Small Business Committee. We are very pleased to have him with us. We are working on his subcommittees right now, and I am sure he is going to be an outstanding member of the committee, and, Rob, you might tell us a tiny bit about your background. I don't know whether you came here as legislator, businessman, or what.

Mr. Portman. Thank you.

First of all, thanks for welcoming me and thank you, Mr. Chairman, for welcoming me to the committee. I am excited to be here. I do have a small business background in the sense that I grew up in a small business family. My father started a business with three other people on borrowed money some 32 years ago, and that business is now a successful undertaking in my district that employs about 250 people.

So, I grew up kind of around the kitchen table talking about small business and its concerns. I went into the legal business and represented a lot of small businesses in Cincinnati. I also spent 2 years, the first 2 years of the Bush administration, in legislative affairs and as Associate Counsel to the President, so I have some Washington experience, and, again, I am just thrilled to be here and to be a part of the committee. Thank you.

Mrs. Meyers. Glad to have you.

Chairman LaFalce. Thank you very much, Mr. Portman. We are extremely pleased at your election. You have great shoes to fill in the shoes of Mr. Bill Gradison because he was one of the truly outstanding Members of Congress, but with the great credentials you have, they obviously have chosen someone more than capable of

filling those shoes. We are delighted to have you on the Small Business Committee.

I would like to apologize to all present. I hate to waste any time whatsoever, and then when we have to waste 20 minutes to vote to approve the journal. That takes 20 to 25 minutes, roughly. It is not just times 400 but times all those people who are sitting here waiting for us to convene. But those are the inefficiencies of most any legislative branch.

On with the hearing.

Today, the committee continues its long-standing inquiry into the credit crunch and the impact of the reduced flow of credit on small business.

For some time now, it has been clear our banks have been reducing their level of lending and increasing their purchases of Treasury securities. This movement toward risk-free banking should have been easy to predict. The S&L crisis and subsequent problems in bank portfolios drove the Bush administration, and too many in Congress, to press banks to purge even the most prudent risks from their portfolios. Rather than become risk managers, they forced them to become risk avoiders.

There have been signs that the economy in general is improving now, but credit is still not flowing as it should. According to recent press reports, business loans, measured as a percentage of gross domestic product, are lower in this economic recovery than in any of the last five recoveries and have continued to decline sharply through the first quarter of this year. In fact, lending to U.S. businesses by U.S. banks declined by $68 billion, or nearly 14 percent, in the 2 years ending this March.

It is small firms, which rely much more heavily on traditional lenders, that always feel the brunt of such trends. Yet it is these same firms that are best able to catalyze the economic growth and create the new jobs that our country so badly needs. Without the financial resources, it is impossible for them to play that role and impossible for our economy to fully recover.

I congratulate this administration for making the ending of the credit crunch one of its top priorities. On March 10, President Clinton announced a series of initiatives designed to increase small business lending. At that time, administration spokespersons indicated we should start seeing some results in June. We meet today to see where we are and where we are going.

When the program was announced, administration representatives indicated that as much as $46 billion in new lending could be expected to result from the credit crunch initiatives. Subsequently, in a hearing this committee held with the regulators several weeks ago, Comptroller Ludwig again indicated that between $38 and $50 billion in new lending could be generated by the "low documentation loan basket" aspect of the President's program alone.

These projections are impressive, but I want to be certain they are real. Despite these optimistic forecasts, committee Members continue to hear from borrowers, and sometimes from bankers, that nothing is really changing. In particular, I remain concerned that loans already on bank books will simply be reclassified into the newly created basket.

I understand it is difficult to determine exactly what, if any, changes in lending patterns might be traceable to the regulatory revisions that have been made, particularly given historical problems in the reporting of small business lending, but we must have some means by which to assess the impact of this important initiative. I would hope Under Secretary Newman would tell us more today about how the administration expects to monitor and assess the results of its program.

This is particularly critical given the relationship the administration appears to see between its credit crunch program and other programs designed to encourage small business lending. For example, President Clinton has himself indicated that some of the restrictions being proposed for the SBA loan guarantee program in fiscal year 1994 would be offset by new lending resulting from the credit crunch initiative. Before we make any dramatic changes in the loan guarantee program, which has been a critical safety valve during the credit crunch, we must have a good sense of what results we can reasonably expect from the credit crunch initiative.

The committee also wishes to know what other initiatives of this nature the administration plans to embrace. The regulators have been working on defining what, if any, statutory changes are essential if we are to put the credit crunch behind us. Their recommendations are expected shortly. We would hope Under Secretary Newman might enlighten us as to the status of that effort and indicate what priority the administration will attach to legislative changes on this issue.

I would very much like to say that the credit crunch problem is behind us, but we have little evidence that it is. Only last week, members of the New England delegation met with the regulators to inquire why banks still did not seem to be back in the business of lending. One very real problem is that some of the restrictions on lending that have been lifted, have been lifted only for the most highly capitalized institutions, and yet, the areas of our country which continue to suffer the most, such as New England and California, don't contain all that many such institutions.

Some believe we may need to extend the benefits of the credit crunch initiative to institutions that are not as well capitalized as we would prefer but are showing signs of significant improvement. I would appreciate the Under Secretary's comments as to whether that would be advisable and also whether legislative changes in existing banking law, such as the prompt corrective action provisions of FDICIA, might be necessary to do that.

Mr. Secretary, we are very appreciative of your taking the time to be with us today before the Small Business Committee to share your perspective on these very important issues.

[Chairman LaFalce's statement may be found in the appendix.]

Mrs. Meyers.

Mrs. MEYERS. Thank you, Mr. Chairman, and thank you Under Secretary Newman for appearing before the committee today. I appreciate this opportunity to hear what progress the administration is making in its efforts to improve credit availability for the Nation's small businesses.

Late this past April, Eugene Ludwig, the Comptroller of the Currency, testified before this committee, along with representatives of

the FDIC and the Office of Thrift Supervision. During the course of Mr. Ludwig's testimony, he pointed to a stack of Federal banking regulations which measured over 15 inches and stated that it is their goal to reduce this stack of regulations to about 3 inches. This, of course, was good news to me and to many other members of this committee, not to mention the millions of small businesses that are presently suffering from a lack of needed capital.

So, Mr. Newman, if you could tell us that stack of regulations is shrinking and will continue to shrink, you will make me and many others quite happy.

One of the things I would like you to address today in your testimony is something beyond the present credit crunch and something that I refer to as the "capital crunch," which is the larger issue which I believe this administration should begin to address, and maybe they already have. Many of this Nation's small businesses could grow, prosper, and create more jobs if they could get the infusion of capital that they need.

Chairman LaFalce and this committee have, for the most part, focused on improving the ability of small firms to grow by getting needed loans from financial institutions. If you could, Mr. Newman, I would like you to also address how we can make it easier for small businesses to get needed capital from other sources, primarily investors, and how we can better attract risk-taking investors to invest in small businesses.

An obvious suggestion would be better tax treatment for capital gains, but I am sure with your background in the private sector you can probably help us with other good ideas, and I look forward to your testimony.

[Mrs. Meyers' statement may be found in the appendix.]

Chairman LaFalce. Are there any other members of the committee who wish to make a statement. Mr. Poshard.

Mr. Poshard. Mr. Chairman, I won't make a formal statement, but I would like to ask unanimous consent to submit an opening statement for the record.

Chairman LaFalce. Without objection, so ordered.

[Mr. Poshard's statement may be found in the appendix.]

Chairman LaFalce. Mr. Zeliff.

Mr. Zeliff. Mr. Chairman, thank you; and welcome to Under Secretary Newman. Being a small businessman from New Hampshire and owning three small businesses, I am well aware of the problems that we have had in New Hampshire. Five out of seven of our major banks have failed. We have been going through some tough times.

I have had seven hearings up in New Hampshire with many of my colleagues. At the hearings, we discussed overregulation and the environment that has been created with the examination process, obviously FDICIA and FIRREA.

Last Friday, the entire New England delegation met with the regulatory agencies. I think it is time to take a look at the President's initiative on basket loans and character loans and see if they really are working.

I know the guidelines have just been released, but I think the key is how many loans are being made, and if they are not being made to move quickly into why they are not being made. I think

we have been dealing with a lot of initiatives in Government operations and small business. I think we have to really get at the root problem. If the President wants to put people back to work, he will have to do it through small business, and if small business does not have access to capital, the economy will come grinding to a halt.

I am looking forward to your insight and thoughts on what you think we can do to help. I look forward to the initiatives the new administration has already made, and, hopefully, we can join together in an effort that would put people back to work and get the economy moving.

Thank you, Mr. Chairman.

Chairman LaFalce. Thanks.

[Mr. Zeliff's statement may be found in the appendix.]

Chairman LaFalce. Mr. Torkildsen.

Mr. Torkildsen. Thank you, Mr. Chairman.

Just very briefly, I would like to thank Under Secretary Newman for being here. What I have noticed, with a district near Congressman Zeliff's, mine is in Massachusetts, there is a very severe inability to borrow money. I am not sure it is a lack of capital but a lack of a process that encourages lending to small business.

What I see is that even with record low- or near record low-interest rates, it is more profitable for many institutions to hold Government securities than it is to make small business loans, largely because of the cost of regulation and the regulatory burden.

To the extent that Under Secretary Newman can address that point, I would be interested in his comments. I think it is a key issue, and I do appreciate this hearing, Mr. Chairman, and Under Secretary Newman testifying today.

Chairman LaFalce. Mr. Newman, now it is time to hear from you.

TESTIMONY OF FRANK NEWMAN, UNDER SECRETARY FOR DOMESTIC FINANCE, DEPARTMENT OF THE TREASURY

Mr. Newman. OK, thank you, Mr. Chairman and members of the committee, I appreciate this opportunity to discuss with you the administration's efforts to improve credit availability and promote the growth and vitality of small businesses. Many of you have encouraged this effort, and we believe the program will be constructive for months and years to come.

I should mention after listening to some of you talk about your own small business backgrounds that it made me recall my own youth. I grew up in a family whereupon my father was a small businessman and started a little printing company literally in the basement of our house. I remember as a boy helping him to set type, and it was all manual in those days. There was no automatic equipment. I helped him run the printing press with a big fly wheel, and it was an interesting time of life.

Most recently, up until February, I was chief financial officer of Bank of America, which is a very active lender to small- and medium-sized businesses.

In responding to some of the issues you mentioned, I hope I can address some of the issues that I know really work inside a real

bank where decisions are made by real loan officers and real credit administrators.

I do not think that I need to take any time to review the problems of the economy, the small businesses, and the whole credit crunch issue. Allow me to address some of the specifics of our credit availability program. We all, I assume, share the objectives of improving the economy, improving the environment for small businesses, and improving employment.

The President's credit availability program was announced on March 10. It concentrates on the regulatory and administrative changes that we could put in place to help small- and medium-sized business borrowers, farm borrowers, and borrowers in low-income communities. Let me take a few minutes to cover the progress of that.

The target date we set for getting most of this done was June 10, which was last week. It was done in a cooperative effort with the major banking agencies—what I mean is the Office of the Comptroller of the Currency, which is part of the Treasury; the Office of Thrift Supervision, which is part of the Treasury; the Federal Reserve; and the FDIC. One of the reasons for putting all the effort into cooperating with the agencies is because it drives the bankers nuts when one agency comes in and says something is fine and a couple weeks later another agency comes in and says it is not fine. What typically happens is that the bank ends up going to the most conservative position in terms of extending credit.

So, we have put a lot of effort into it, and so far it seems to be going well. The people at the Federal Reserve and the FDIC, although they are not part of the administration, share a lot of the same goals, and we have had a very good working relationship.

We have focused on five regulatory areas, and these are things we think are genuinely meaningful. It is not that we are just trying to find something to do that sort of looked good while we figured out what else to do, like possible legislation. These actions, from my own experience in the banking industry, are genuinely important. We will come to the issue in a few moments about how long it takes to get these things to actually filter through the banking system and really affect genuine lending decisions, but we believe they are genuinely meaningful.

First, the agencies took a set of steps to eliminate impediments to lending to small- and medium-sized businesses by allowing one- and two-rated banks to create a basket of minimal documentation loans.

We are aware that this committee has raised the question of, in addition to the one- and two-rated institutions being eligible for this minimum documentation program, extending the program so that at least the strongest of the three-rated institutions could participate.

Gene Ludwig, Comptroller of the Currency, is very much aware of this. We have had some conversations about how to address that issue. It seems like a very legitimate question, and we are working on it.

Chairman LaFalce. We realize sometimes the Banking Committee comes in with a more conservative posture on all these issues, and we have to come in and provide you with a perspective based

on economic growth and stimulation of the economy. You have to find the right balance.

Mr. NEWMAN. Thank you, Mr. Chairman; that is, indeed, part of the job. We have been very careful in all of our efforts to try to identify areas that genuinely do not materially impair the safety and soundness of the banking system. As a matter of fact, quite to the contrary, we think a number of these things are immaterial. They have impeded lending without substantively adding to safety and soundness and, in fact, have diverted examiner attention from other issues which may be more relevant to genuine safety and soundness.

So, one of the things we want to do is get the examiner's attention away from things which are sort of make-work and small time and have them put their attention onto issues which genuinely affect the overall risk of an institution or a set of institutions.

We are taking this issue, the question about extending the minimum documentation, seriously. I do not have an answer for you today. The rating system itself is established on a one-to-five scale, and it does not have built into it something like an improving three rating or a declining three rating. That concept alone is worth consideration, and we did have a conversation this very week among the Federal banking agencies. So, we are treating that as a serious issue.

In addition, last week, we put out an interagency policy sheet clarifying sort of an arcane categorization issue, of loans called other assets especially mentioned. This is one of those things that sounds very technical but actually affects a lot of banks in their lending, particularly to small businesses.

Basically, aside from the category of loss, the examiners have, when they classify loans, a category called "doubtful," which are the worst of the loans that have not yet turned into a loss. Historically, maybe something on the order of 50 percent of those loans, in aggregate, ultimately turn into loss over the upcoming years. Then the next most severe category is called "substandard," and there may be 10 to 20 percent of those loans that turn into loss. Then there is another category, which is not even technically called classified; it is called "other assets especially mentioned," which might have minor problems associated with them. Of these loans, typically 1 to 5 percent of these turn into a loss.

What happened in many processes was that the examiners were taking a bunch of loans in the latter category that had a very small probability of turning into loss, lumping them with those that had a high probability of loss, comparing them to capital reserves, and coming in and telling a board of directors that the bank had a major problem, when, in fact, if you really looked at the underlying risk on a statistical basis, that might not be the case.

This particularly affects small business loans because a lot of small business loans are placed in the special mention asset category even though they may be a perfectly reasonable lending decision for a banker to make.

There is a lot of judgment that goes in there. Two perfectly reasonable people could say, I think this has a 1 percent; I think this has a 3 or 4 percent probability of loss and put it in that group or not.

This clarification that just went out last week, specifically instructs the examiners that they may not aggregate these special mention assets with classified loans in the reports of examination, or in processing applications or in making reports to boards of directors on asset quality. It does not mean it can not be looked at, because it may be a leading indicator, but it needs to be treated separately and properly.

[Mr. Newman's statement may be found in the appendix.]

Chairman LaFalce. Let me understand this a little better. For the most part, small business loans have been put in a special mention asset category?

Mr. Newman. Those that are questionable, Mr. Chairman, are often placed in that category. Some of them, obviously, have more severe problems that would fall into a higher category. Some have no problem whatsoever, but a large proportion of them fall into an area where there is some risk associated with them, which is perfectly reasonable.

As you pointed out in your letter to the President earlier this year——

Chairman LaFalce. Now, what percentage? Do we have any data on what percentage of small business loans are put into this category?

Mr. Newman. Data on this issue is mostly anecdotal. One of the problems getting data about small business loans, is that, in general, the industry does not have good, coordinated computer systems for processing small business loans in the same systematic way in which loans such as mortgages, which have a much larger number of loans, are processed. So, often a bank will have a couple of different systems that keep the data in slightly different ways for different categories of small business loans.

Chairman LaFalce. Are there any major banks that do have sophisticated computer systems, such as BOA or Citicorp, where we could get some handle on what percentage of nonguaranteed small business loans are almost automatically being tossed into that category?

Mr. Newman. That is a good question, Mr. Chairman. I do not know, and we will find out.

Chairman LaFalce. What is the consequence of that? Once they are put in there, have the examiners been considering them as substandard, doubtful, or loss almost automatically?

Mr. Newman. That is exactly the issue. In some cases the examiners have looked at it and said, well, it is a factor to keep in mind, but it is not a major risk and we are really concentrating on the genuine classified loans which are the substandard and doubtful.

In some other cases, particularly as we have gone through the past few years where there has been a great deal of emphasis on risk minimization, some examiners have taken that category and lumped it in with the others so that the figures that are presented to the management and to the directors of a bank, would include the aggregate of the substandard, doubtful, loss loans, and these special mention assets all in one large number. That, obviously, has a tendency to make the bank management and the directors risk averse.

Chairman LaFalce. It might be interesting to take a look at those institutions that have been closed to see how the examiners treated that classification of loans at that time. It may be informative.

Mr. Newman. That is a fair question, Mr. Chairman. I believe that the actual closing decision was not so much influenced by this, because it is a separate process of decisions. In determining the proper reserve requirement, the examiners typically did use this 1 to 5 percent range. But in determining what to bring to the attention of a board of directors, they would not apply the percentage factor; they would just use the gross amount.

Chairman LaFalce. Please continue.

Let me go on to your second point. Another key thing that just came out recently was the real estate appraisal requirement, which had been a real burden for banks. The threshold level above which an appraisal is required was raised from $100,000 to $250,000. This action is particularly important for small businesses because a large number of small business loans have real estate as part of the collateral.

Now, it is the local hardware store that happens to own its building in which the store is located, and when that hardware store goes to apply for a loan, it is really the cash-flow of the hardware business that is the principal consideration for the lender, but the lender will also often take the deed to the building as a backup source of repayment, and it becomes important for many small businesses.

The cost of an appraisal was so large relative to the size of the loan that it made some loans uneconomical. So, by raising this threshold from $100,000 to $250,000, we think that will help borrowers a great deal. The proposal has just come out within the past few weeks, so it will take a while for that to filter through the system.

Chairman LaFalce. That is just a proposed rule, not an effective rule.

Mr. Newman. That is correct, it is a proposed rule and for which we are required to get public comment.

Chairman LaFalce. If all goes well, when would the effective date of that be?

Mr. Newman. Mr. Chairman, the proposed rule is expected to become effective in September.

Chairman LaFalce. All right. There are some individuals who are saying you are opening the door to another debacle. I don't know that to be the case at all, but I am just wondering. They are saying, how could you raise it from $100,000 to $250,000. I don't think the $250,000 figure presented problems historically and will not in the future.

Mr. Newman. I absolutely agree with you, Mr. Chairman. We went back and did some historical studies of institutions that had failed prior to this real estate appraisal requirement being put into place, and we could not find a single institution that had failed as a result of making $200,000 loans without appraisals. That is just not what brought down real banks in the real world.

Chairman LaFalce. Could you flesh that out in writing for this committee?

Mr. NEWMAN. Sure.

[The information may be found in the appendix.]

Mrs. MEYERS. Mr. Chairman.

Chairman LAFALCE. Mrs. Meyers.

Mrs. MEYERS. Is there a level at which you did find that institutions were taken down because they had made loans without appraisals?

Mr. NEWMAN. That is a good question, a fair question, Congresswoman Meyers, but the answer is we did not do that kind of complete statistical study. We just went through a number of the records.

Mrs. MEYERS. You just know the $250,000 level; you had no evidence that in itself had been a factor in the failure of an institution?

Mr. NEWMAN. That is correct.

Mr. ZELIFF. Mr. Chairman, may I make a comment?

Chairman LAFALCE. Yes.

Mr. ZELIFF. The problem is that with the cost of the appraisals and all the rest of the expense of doing a loan at a cap of $100,000, it just makes the loan unprofitable. If you spend $15,000 or $20,000 to get a loan, and you have to put the interest and everything else, you will never be able to get expansion and hire more people. It is a crazy scenario, so to your credit, I think this is a step very much in the right direction.

Chairman LAFALCE. Go on to your next points, Mr. Newman.

Mr. NEWMAN. We did a couple other things in the interagency policy statement, relating specifically to real estate, for example. We revised some of the regulations associated with what is involved for a piece of real estate to be classified, a real estate loan to be classified as real estate owned by the bank. Previously, there were circumstances under which a real estate——

Chairman LAFALCE. Are you talking about OREO and foreclosure?

Mr. NEWMAN. Exactly.

Chairman LAFALCE. Explain that.

Mr. NEWMAN. There is a term called OREO, which stands for other real estate owned by a bank. What often would happen is when there was a loan that was collateralized by real estate, if the bank actually foreclosed on the real estate, took ownership of the properties, then that was reclassified on the balance sheet and wasn't a loan. It was classified as OREO. OREO is, by definition, a problem asset.

But there were also some circumstances in which the bank did not take possession of the loan, but there was some anticipation that it might take possession of the property, and the examiners were requiring that those loans be reclassified as OREO even when there was no repossession of the property, and there was not even an indication there was going to be a repossession of the property. So, that has now been clarified so that situation will not prevail.

Similarly, once there is a piece of property that is owned by a bank, we have revised some of the requirements for selling that property which we thought were overly restrictive for financing the sale of that property.

We have also introduced what we think are significant improvements in the appeals process. Appeals are very difficult for banks. When an institution feels that an examiner has been overly harsh in an overall examination or in a particular case, it is very difficult to complain about it, because the truth is that the bank is, in many ways, at the mercy of the views of the local examiner.

So, we have tried to create a situation which Gene Ludwig and the OCC calls an ombudsman, which is a totally separate line for reporting directly to the Comptroller of the Currency. On a confidential basis, a banker can file an appeal to the ombudsman and just say, "I think this particular issue needs to be looked at again." The ombudsman, obviously, needs to be very objective and balanced in the judgments he or she makes.

It is too early to tell how well that process is going to work. I, frankly, have to tell you it is a very, very difficult issue because of the human interaction. Whenever you have an examiner onsite, overruling that examiner in any fashion is very difficult, but we are going to try to make it work as best we can.

Another thing I already referred to before, which is a very strong effort to eliminate duplicative examination processes and procedures, to not have duplicate exams in the first place when they are not warranted, and, when they are required by law, to have them done jointly rather than having one group of examiners come in and then a few weeks later having another group of examiners coming in and sort of disrupting the bank a second time.

Chairman LaFalce. These are different agency regulators or with the same regulator?

Mr. Newman. This is primarily a problem with different regulators. There are situations where, for example, in a nationally supervised bank, the Comptroller of the Currency examiners will come in and then the FDIC examiners will come in at a later date separately. There have similarly been some issues of coordination with the State bank examiners. That is more difficult. It is something we need to work on more actively.

There have also been some situations where the Federal Reserve, because of its authority over a bank holding company, was involved in an examination of a bank holding company while the Comptroller was examining the lead bank, which is a national bank, and they might not have been coming in at the same time. We are making efforts to see that they come in now at the same time.

The last thing I wanted to mention was that the OCC in particular has begun to use new procedures to detect discrimination, particularly in residential lending, by national banks to ensure that credit is available more broadly and more fairly.

In addition to the examination procedures, the OCC is developing a pilot program to use minority and nonminority testers to go into, actually walk into branches and to identify discrimination in the ways in which banks treat potential borrowers. This is something that we are starting on mortgage lending, but should be extended to small business lending. The same concept applies.

There is no reason in the world why there should be any discrimination on the basis of gender, race, or background for borrowers of any sort in any financial institution in this country. We are very, very serious about pursuing this issue.

Some of the regulatory changes we are working on will take a longer time to implement. We have submitted a list in the written testimony that includes a review of the paperwork. This is some of the stack of documents that Gene Ludwig referred to: Corporate applications, documentation requirements. This is going to be a major task. It will take a while, and we will have to keep chugging away at that.

One of the most difficult tasks we actually face is changing the cautious culture that pervades a lot of the regulatory agencies. During the recession, the examiners worked hard to minimize almost every risk they could, often urging bankers to be as conservative as possible, consistent with safety and soundness. Now, even though we do not have a robust economic expansion, the recession is officially over, and bankers must get back to prudent risk-taking in support of economic growth.

To achieve this objective, we developed rules which are clear enough for everyone to understand what is expected. In addition, there are training sessions and meetings for examiners with senior officials to explain the credit availability program.

The Comptroller has already begun a series of meetings with the examiners in each of the OCC districts around the country to talk with them directly, to get some feedback from them, to try to get the sense of what we are trying to do here better understood by the individual examiners. That is a really challenging issue.

I would like to turn for a moment to some of the other administration efforts to promote small business growth. The President's National Economic Council has established an interagency working group on new and growing businesses which has been examining proposals to promote small business growth from some of the more standard programs to the more theoretical and hypothetical.

For example, one important method of providing credit to the small business community is through the SBA 7(a) Program, which guarantees bank loans to small businesses, and funding the 7(a) Program was a part of the administration's economic stimulus package, a program I am happy to note has the strong support of Chairman LaFalce and other members of the committee.

As a result of that bill's demise, however, a program that is widely supported, and annually funded, has suddenly come to a halt. One of the most important things to do is to get new funding for the 7(a) Program as promptly as possible.

Some of the more innovative proposals would facilitate investment in small business organizations by investment companies. This partly addresses the issue that Congresswoman Meyers asked about earlier. Chairman LaFalce and I have had some brief discussion about the need to address ways to provide capital as contrasted to loans for small and growing businesses. That is coming. We will be giving increasing attention to this issue.

Chairman LaFalce. Are you chairing that task force looking into the secondary market issue?

Mr. Newman. Actually, the task force is being chaired by the National Economic Council. The Treasury is an active participant in that activity, though.

Chairman LaFalce. Who is the lead person from NEC; do you know offhand? Staff?

Mr. NEWMAN. Ellen Seidman, who works with Bo Cutter and Bob Rubin.

In terms of looking at a secondary market for securitized small business loans, which obviously you have an interest in, and, Mr. Chairman, I know you have sponsored a very thoughtful bill regarding it, that is something we are just starting to look at. Treasury will be very active in looking at this issue and the alternatives that have been proposed. It is something we believe calls for very serious consideration.

We are happy that you have taken the leadership to put a concrete proposal on the table that will be very helpful in terms of looking at all these issues. As I mentioned before, our focus, our concentration up until now, aside from specialized things like the RTC, has really been on these administrative programs, the regulatory programs which we felt we could get into operation very quickly and which, in fact, have a very high likely payoff, and we are really now just turning our attention to some potential legislative issues.

I should also mention something here about the RTC, partly because it relates to today's issues, and partly because it turns out that today is the 60th anniversary, I am told, of the enactment of the legislation putting the Federal Deposit Insurance System into place. But we do have over $33 billion worth of assets in institutions that are in conservatorship by the RTC right now. We have nearly 4 million depositors with an average balance of approximately $9,000.

Chairman LAFALCE. How much do you have in the RTC right now?

Mr. NEWMAN. In the conservatorships, in institutions that have not yet been resolved and are being kept open as best we can at the moment because we don't have the funds, there are about $33 billion of assets and nearly 4 million deposit accounts, with an average balance of $9,000, roughly, in each of those 4 million accounts. These are 4 million account holders, Americans, who are counting on this Government to provide the funds necessary for their deposits to be made good.

Chairman LAFALCE. They are not hurting right now, though, are they? They have not suffered in any way.

Mr. NEWMAN. They have not suffered directly, and they will not unless Congress fails to provide funding to the RTC so that these deposits can be made good.

Chairman LAFALCE. Interest rates have continued to go down so that has not exacerbated the problem. In fact, it has eased the problem, hasn't it?

Mr. NEWMAN. That is true, although——

Chairman LAFALCE. People used to say, every day we don't close them down, we lose $6 million a day. I never could figure out that math.

Mr. NEWMAN. That number has come down, Mr. Chairman. It is now nearly on the order of $3 million a day. The reason for that——

Chairman LAFALCE. Lower interest rates.

Mrs. MEYERS. I am still not happy.

Mr. NEWMAN. That is a big number.

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Chairman LaFalce. That is right. But is it true?

Mr. Newman. Yes; it is Mr. Chairman. It was higher because, as you say, interest rates were higher.

But there are two causes for it. One is that the Government essentially owns these conservatorships right now. They are, by and large, losing money. They are high overhead operations. They are not real businesses and are not making new loans. They are not operating like a real business. We are just acting as house sitters for them. There is a lot of overhead that is just sheer cost in keeping these institutions open.

Whereas, if we could shut them down, sell them off to a live institution that could incorporate them into their ongoing operations——

Chairman LaFalce. Whether you operate at a loss or not depends on how much you would sell them off for.

Mr. Newman. That is true, although the——

Chairman LaFalce. I never really thought the figures we got from the administration bore any relationship to reality because they didn't make that comparison amongst others.

Mr. Newman. That is true and you are right, Mr. Chairman. We have gone through exactly that computation. That does need to be taken into account, the sales price.

The other reason for their cost is that essentially the deposit rates that are being paid in these institutions right now amount to a form of Government borrowing. Since the Government owns these institutions, when these institutions pay an interest rate that is above the Treasury rate to a depositor, essentially it is costing the Government more than directly borrowing through the Treasury.

We estimate that the "all-in" cost differential—interest and overhead costs—between the Government borrowing through insured deposits and the Government borrowing directly through the Treasury is about 2.55 percent. Multiplying the cost differential by the dollar amount of liabilities of the conservatorships yields an annual costs differential of around $1 billion, or about $3 billion a day.

Chairman LaFalce. But aren't these institutions putting their money in Government securities?

Mr. Newman. Well, if they are, that, in fact, is losing money. If the institution pays, for example——

Chairman LaFalce. I thought they were making money because of the spread—that what they are paying depositors is less than what they are getting on Government securities.

Mr. Newman. That was an interesting issue raised before. If an institution takes in a short-term deposit and places it in a long-term Treasury, then that institution, in today's yield curve environment, will make money. But that is only by taking an interest rate risk. To the extent it is taking an undue amount of interest rate risk——

Chairman LaFalce. Which is not yet counted as a real risk under the Basel risk-based capital standards.

Mr. Newman. Which we are just coming forward with standards for, Mr. Chairman.

Chairman LaFalce. When will they be out?

Mr. NEWMAN. Very, very shortly. In a matter of weeks.

Chairman LAFALCE. Will they phase these in?

Mr. NEWMAN. The interest rate risk regulations?

Chairman LAFALCE. Yes.

Mr. NEWMAN. It will be phased in. We will give people notice. Actually, the industry has received a fair amount of notice already as to the basic intent, besides which there has been, for a long time, the tenet that has been part of the examination process, it just has not been incorporated into the capital standards, that that interest rate risk management is a responsibility of every financial institution, just as credit-risk management is a responsibility of the institution.

It does not mean that an institution may not take any interest rate risk, just as we don't mean to tell an institution that it may not take any credit risk. Quite to the contrary, an institution should take credit risk. It must take credit risk in order to perform its economic function. It just has to be prudent, managed, diversified credit risk. An institution can take the interest rate risk, but it needs to be prudently managed.

In these institutions that belong to the Government, by and large, they have been operated prudently without taking excessive interest rate risk, which typically means that, say, a 3-month deposit might come in, and the institution might pay, for example, 3.5 percent. The institution might turn around and take those very same funds and put them into a 3-month Treasury bill for 2.9 percent. That differential, that six-tenth's of 1 percent, is a cost to the Government, flat out, every day, in and out, unequivocal measurable cost to the Government.

That is the major contributor to this roughly $3 million a day, $100 million a month cost. Every month that we delay giving funds to the RTC to shut down these institutions is costing the Federal Government about $100 million.

Chairman LAFALCE. But most financial institutions would not do that, pay out 3.5 and invest at 2.9.

Mr. NEWMAN. That is part of the problem.

Chairman LAFALCE. I mean, maybe only the Federal Government would.

Mr. NEWMAN. Well, you see part of the problem in these conservatorships is they are being managed on a temporary basis.

Chairman LAFALCE. That doesn't mean they have to be managed unwisely.

Mr. NEWMAN. It is not clear——

Chairman LAFALCE. Are they really doing that?

Mr. NEWMAN. They are doing that. Partly, these institutions have been so devastated——

Chairman LAFALCE. Can't we change that? They should not be doing that.

Mr. NEWMAN. They don't have the infrastructure for making loans, Mr. Chairman.

Chairman LAFALCE. I am talking about just investing in other types of securities.

Mr. NEWMAN. If they don't have the infrastructure for making loans and the only viable alternative is to invest in a Treasury se-

curity, if they invest in a longer term Treasury security, they are taking interest rate risk.

Chairman LaFalce. Isn't that better than taking a loss? How long would you have to go out to get 3.5 as opposed to 2.9?

Mr. Newman. I don't know the answer off the top of my head, but the problem is when that institution is ultimately sold to a buyer, that buyer will come in and evaluate the degree of interest rate risk that the institution has, and, to the extent that the institution has unmatched interest rate risk, it will reduce the price that the buyer is willing to pay for it.

Mrs. Meyers. Mr. Chairman.

Chairman LaFalce. Yes.

Mrs. Meyers. I have supported this every time it has been in front of me, and I think I agree with you. I think we are postponing the inevitable, and it has been a very expensive postponing that we have been doing.

What is the administration doing and where is this right now?

Mr. Newman. The RTC bill itself has now been passed by the House Banking Committee, bipartisan vote of 35 to 16; it has been passed on the floor of the Senate, again a bipartisan vote of 61 to 35, and it should be coming to the floor of the House, hopefully, soon.

Chairman LaFalce. It had sequential referral to the Judiciary Committee. The Judiciary Committee acted on that last week?

Mr. Newman. Correct.

Chairman LaFalce. Reported it out. There was also a problem, Jan, with the operation on the ranking minority member, Mr. Leach, and I think that impeded its progress somewhat, too. He is now back.

Ms. Danner. Mr. Chairman.

Chairman LaFalce. Ms. Danner.

Ms. Danner. If we may go back to your testimony, I am looking at the clock. On page 4, you talked about the interagency policy statement on the documentation of loans, minimal documentation, and you cite the figure of 20 percent of total capital. How did you arrive at that? Do you think that is a large enough figure? Documentation seems to be the thing I hear from not only my bankers, but the business people, and my individuals.

Mr. Newman. There is nothing magical, Congresswoman, about the 20-percent number, and we debated it actively in Treasury and amongst the four regulatory agencies. Part of the concern is that it is potentially subject to abuse.

If a bank uses it properly, they will be making perfectly sound loans that do not happen to be documented according to some standard. But we have all seen institutions that failed where part of the problem was that the documentation not only did not meet sort of basic standards, but really did not contain what was necessary to make a sound credit judgment. That has been a contributing cause to some failures.

The 20 percent of capital was a number that we thought was safe; that even if some banks were very liberal in the way they treated the lack of documentation, that only 20 percent of that capital would be at risk, and we wanted to wait a while to see how it went.

If, in fact, we come back in a year and find a number of banks have gone to the 20-percent threshold, and they say to us, gee, if you could only make this 25 percent, we would make some more loans, and please take a look and see the way we are using this is perfectly prudent, then we will take another look at that number. But going from zero to 20 percent, we want to have a little experience.

Ms. DANNER. Well, that lack of documentation has been obviously part of the problem in leading to the RTC, but in the recent past, past year I would assume, you have not had that much problem with lack of documentation because there has been so much of it, it seems to me.

Mr. NEWMAN. The failures in the past year have been relatively modest compared to what they were in some prior years, but there are 12,000 institutions in this country that are affected. Sometimes, a lax management will treat lack of documentation requirements as a way to make loans that really just have not been looked at sufficiently.

Again, as Chairman LaFalce mentioned earlier, we are trying hard to find a balance between something that will give the banks the opportunity to extend credit whereupon they have not been before without endangering the safety and soundness. We felt 20 percent was a reasonable first step, and, indeed, if, in fact, we find that becomes a constraining factor, we will look at it again.

Ms. DANNER. Thank you. Thank you, Mr. Chairman.

Chairman LAFALCE. Mr. Baker.

Mr. BAKER. Thank you, Mr. Chairman.

Chairman LAFALCE. We have been proceeding rather informally, as you know. We have not been following the 5-minute rule rigidly.

Mr. BAKER. I appreciate the emphasis on not following the 5-minute rule, Mr. Chairman. Thank you very much.

Chairman LAFALCE. Rigidly.

Mr. BAKER. Mr. Under Secretary, I have read and listened carefully to your comments this morning and certainly appreciate your interest in the regulatory reform issue and somehow figuring out how to get access to credit to small business.

I went back to the President's opening address delivered March 10 when he began to talk about concerns about the credit crunch and what should be done. One of the things in his comments that I found of interest, because it was not a point referenced by you this morning, was with regard to meaningful compliance with community reinvestment and to promote fair opportunities, and he went on in that comment.

I am somewhat perplexed at the moment with regard to discussions by the administration proposing community development bank activities and perhaps heightening community reinvestment standards at the same time. Do you have a view today on whether community development banks, as has been discussed in the general sense, will become a legislative proposal? Will it, if proposed, be in coordination with enhanced community reinvestment? How does this enhance credit availability for traditional small business?

Mr. NEWMAN. Congressman Baker, let me take that question piece by piece.

We anticipate proposing community development bank legislation to the Congress in the near future. We have been working actively to put together a program we think makes sense. It is a relatively modest program in comparison to some that have been discussed. It is a program we hope will foster the most private sector participation possible.

Chairman LAFALCE. If I could interrupt for a second. I think Mr. Baker has asked an important question, and it is an interesting answer, but I want the world to have some perspective on this issue.

We have been talking about getting loans out to the small business community. We have been talking about increasing loans by from $40 to $60 billion with these regulatory changes. Community development banks are talking $382 million over a 4-year period, leveraging in the range of $1 to $2 private dollars for every Federal dollar, and yet the front page headlines will be about the community development bank proposals and very little about these regulatory changes to get tens of billions of dollars out to the small business community. But please proceed.

Mr. NEWMAN. We should also note on that line, Mr. Chairman, a few hundred million authorization for the SBA could get billions of dollars of small business loans.

Chairman LAFALCE. We have $181 million that would leverage $3.3 billion worth of loans. Right.

Mrs. MEYERS. But it has not passed the Senate, and it looks like there are some problems with it over there.

Mr. NEWMAN. Part of the underlying concept behind the community development bank proposal will be sort of the seed money concept; to encourage the private sector participation as much as possible; to build on what is already successful; to provide a base of knowledge and training for groups that want to start up new institutions, again with private sector capital and participating with the Government funding as much as possible.

These institutions themselves will be one mechanism for providing credit for small businesses in the most distressed communities. But this program is really targeted toward the most distressed communities, both urban and rural. It is not a program that would apply to the same kind of broad range of virtually every community that the Community Reinvestment Act does or the SBA Program does.

Mr. BAKER. So, you see community development banks as being an augmented program really to the basic underlying elements of CRA, which may be, in fact, at some future point, revisited or expanded, if that is possible?

Mr. NEWMAN. Yes; changes to CRA are not envisioned in the community development bank proposal. It is a complement; it is a supplement; it is a separate program. We are separately addressing how to best implement the existing CRA legislation in terms of performance measurement in banks.

There is a general agreement which we share in Treasury and in the regulatory bodies that there has been far too much emphasis on paperwork in the CRA and not enough emphasis on performance and actually making loans.

Chairman LAFALCE. It has been all paperwork.

Mr. BAKER. Let me add one more observation with regard to sort of a sequential step. If community development bank initiatives or if our community reinvestment is made to work, isn't it more of an economic reality for a banker sitting inside—the loan closing lender today, he is worried about the regulator classifying loans and getting a bad CRA report or getting more loans classified because he has extended credit which may not be repaid.

At the same time, most small business lending is portfolio lending. You cannot sell it, you cannot get rid of it, but yet the Congress has required a higher risk-based capital reserve against small business lending than any other.

So, if you are a banker sitting in the real world, you have to put more of your capital aside to offset the potential risk of the small business lending. If you make the loan to the small businessman, particularly in an inner city, it is likely to be the highest area of criticism by a Federal regulator. Given the yield curve and other possible investments, why make small business loans, period? Isn't it much wiser not to be in the market?

Wouldn't the response which would make sense be to allow the spread of risk, to encourage the local lender who knows the character of the individual and who could then market the loan in the secondary market, would be the creation of a nongovernment guaranteed secondary market system to acquire small business and commercial loans in large packages? Wouldn't that do a great deal more, frankly, than wrestling with regulatory relief at the moment?

Because the practical aspect is, what do you do with it if you catch it? It is like the small dog and the big car. It is a great thing to chase and bark at it, but if you finally catch it, it is going to kill you. What we need is a way for a bank to originate loans and get them out into a secondary market opportunity so he can service the loan, originate it, make a small profit, and get rid of the risk.

Mr. NEWMAN. I guess I would agree that some sort of a multifaceted approach is appropriate here. To the extent we can create multiple vehicles that the private sector can choose from, that is great.

The capital rules per se, the technical capital rules, do not require any more capital for a small business loan than for any other loan, the one exception being home mortgage loans require only half as much. But the small business loan has the same capital requirement as a credit card loan or a home equity loan or anything else like that.

The thing that has happened is the point that I mentioned earlier, Congressman, about the special mention assets, has led to sort of an indirect, unofficial penalty against capital. That has been the problem that has happened.

There is no technical requirement these loans have any more capital to them, but to the extent that examiners have taken these small business loans, put them in the other assets especially mentioned category, and then used that category, lumped it in with the more severely criticized substandard and doubtful loans, and presented that as a ratio to capital, has indirectly led to this problem of leaving the banker with the impression that, in fact, he or she needed more capital for these loans.

By addressing this special mention asset issue and specifically instructing examiners they absolutely may not lump them together for purposes of capital comparison, we hope to significantly address that issue.

Mr. BAKER. But there is no distinction technically between investing in a Treasury security and making an operating line of credit available to a small business.

Mr. NEWMAN. A Treasury security has a zero-percent mask weight.

Mr. BAKER. Mortgage-backed security is treated differently.

Mr. NEWMAN. Mortgage-backed securities have a 50-percent risk weight.

Mr. BAKER. So that you have really three classes of classification. Something in the Treasury classifying a mortgage-backed security and a line of credit that runs to small business.

Mr. NEWMAN. Yes; or again, any loan, with the exception of single family mortgage loans, any loan of any sort, consumer loan, small business loan, big business loan, whatever, all falls into one category for capital allocation. If the institution feels that its choice is to make a loan or to invest in a Treasury security, it does not have a risk-based capital requirement against a Treasury security.

But the only way for an institution to make any money by investing in a Treasury security is by taking interest rate risk, and most of the institutions that I have talked with really want to make the loans. That is the business they are in. They would like to make a profit off the loans; they just feel that the environment has been very harsh.

Chairman LAFALCE. They have been taking that risk gladly, gleefully, and making a lot of profit on it in larger sums and larger percentages than ever before historically.

Mr. NEWMAN. The question of how much the economy has affected this, of course, one will never know. It is the reason for the multifaceted approach. The deficit reduction program, in a sense, is part of this, too. Anything that makes the economy more stable and the long-term outlook better is going to help.

Having some form of a securitization market is absolutely worth very serious consideration, and I agree. Chairman LaFalce has a bill, and there are a couple of other bills that have been proposed. We have not yet had an opportunity to examine them in-depth, and there are clearly a number of issues.

There is the issue about Government risk, about budget scoring, about homogeneity. There is a great debate, as I am sure you know, in the banking industry about how well, how best to make this kind of a program work as contrasted to a home mortgage securitization program when home mortgages are much easier to make homogeneous than small business loans.

Chairman LAFALCE. One of the things we hope to do with these small business regulatory relief initiatives is to revitalize the concept of character loans. The last thing you want to do is sell off a character loan into the secondary market. So, you need both approaches.

Mr. BAKER. One last follow-up, and it slides on into regulatory relief.

You made no comment about Mr. Bereuter's resolution 962, which has a significant number of cosponsors, perhaps 250. The first mortgage loan closing document package is now in the range of 50 to 70 pages, depending upon the sophistication of the deal.

I asked a representative of a consumer advocacy group recently in a public hearing whether they found one or more of the recurrent requirements that could be consolidated or eliminated to help enhance credit accessibility. We are still waiting on a first recommendation.

Could you make any comment with regard to specific regulatory provisions that may be under review for elimination; the HMDA 3-day rider rescission? Most people are saying take the 3-day rider rescission and make it 5 for most permanently insured traditional banking interests.

Most folks, when they get to the closing table, don't say why don't we wait longer so I can think about this. They say, you mean I don't get my money today? It is not a traditional source of problem, given all the preclosing disclosures which are made, much less the notices at closing. We are drowned in paperwork. People who make a loan don't understand what they are signing anyway, and the more paper we give to make sure they understand better, it makes it less likely they read it.

Can't we simplify this somehow down to maybe 10 or 20 pages?

Mr. NEWMAN. Clearly, this issue needs to be looked at, Congressman. Let me try to put the issues into two different categories.

One category are those that literally impede lending, and that is where we have been giving our first attention, and have found that most of the issues that appear to genuinely impede lending in real live institutions can be addressed through these administrative and regulatory programs we are doing.

There are some legislative issues that definitely bear looking into, and we will move on to them shortly, and we will be using that bill as one of the means for looking at it, where there is reason to believe that there may be some provisions in law that are having unintended consequences in the actual extension of credit.

There is a separate set of issues, at least in my mind, which are sort of overhead burden, where they are not literally impeding credit. The mortgage loan gets made. It is not that the loan does not get made, but it gets made with a tremendous amount of cost and a tremendous amount of time for both the borrower and the lender. There may be a lot of overhead, and forms filled out, and other things, regulatory burden, which are particularly a burden, I think, on the smaller institutions.

What happens is some of these, the regulatory burden, if it is a large institution, can sort of be spread over a larger base of assets, but in a smaller institution becomes a higher proportion of total expense, and is a real drain on expense. Ultimately anything that is an unnecessary expense to a financial institution becomes an ultimate drain on its capital building, and capital building, of course, is necessary for its ability to grow its loan portfolio. So, it all does tie in.

But that second category of things, which is regulatory burden efficiency issues, rather than literally impeding loans, is something

we will look at. Again, we will look carefully at the bill you just mentioned, but it is a second step, if you will.

Mr. BAKER. Thank you, Mr. Chairman.

Chairman LAFALCE. Ms. Margolies-Mezvinsky.

Ms. MARGOLIES-MEZVINSKY. Thank you, Mr. Chairman.

This past Friday we held a business roundtable in our district, and I just wanted to know if you could answer some of the questions that were posed by the businessmen, frustrated businessmen in our area. Many of the business owners in my district complain that Federal regulators are too concerned with enforcement of regulations rather than helping businesses comply with them.

How would you answer those businessmen? What direction could you give them? What hope could you give them with this new direction, if there is one?

Mr. NEWMAN. Well, Congresswoman, that is one of the more difficult issues, because it gets down to sort of the psychology of how the local examiners behave, and the culture that then gets passed on inside the financial institution itself, inside the bank.

We are, in addition to issuing these regulations, having these meetings I mentioned, and meetings and exhortations themselves do not do the trick. It is necessary to give the examiner a specific new regulation that says, this is the rule. Examiners have been trained to follow the rules. It will go in their notebook, their policy manual. It is much, much more than just giving speeches.

Also, I think it turns out to be beneficial that the program has been issuing a series of revised regulations over these past 3 months, because every couple of weeks the examiners in the field get another reminder that, hey, the administration is serious about this because it wasn't just one regulation that came out on March 10 and everyone forgot about it, but every couple of weeks there is another one that is consistent with the general direction, and it creates a whole attitude. But the truth is it will take a while for that to infiltrate.

What happened was the very conservative attitude of the examiners infiltrated the banks, because the banks learned that if they did not want to get beaten up by the examiners, here is how they had to behave, and it took a while for that to happen. Now we have to have a reverse trend of that, not, again, jeopardizing safety and soundness, but with more balance. The bankers have to be balanced, and the examiners have to, in fact, become more balanced.

Ms. MARGOLIES-MEZVINSKY. Can you tell us more about the training sessions you mentioned? What kind of impact will they have, and is there any way that you can incorporate into those training sessions some of the things you just mentioned?

Mr. NEWMAN. Yes; Gene Ludwig at the OCC has been a leader on this, although the other regulatory agencies are also starting up training programs. They are being done largely onsite in the individual districts or regions of the agencies, so that Gene and his senior staff are personally appearing onsite not only to give the training——

Ms. MARGOLIES-MEZVINSKY. Will we be notified when these things are going on? Could we be notified?

Mr. NEWMAN. In your own district?

Ms. MARGOLIES-MEZVINSKY. In our area.

Mr. NEWMAN. I don't see why not.

Ms. MARGOLIES-MEZVINSKY. Continue. I didn't mean to interrupt you.

Mr. NEWMAN. They are going through the series of regulations that have been issued, responding to questions, making sure that the underlying concept is understood and in some cases, in some ways just the sheer physical presence of the senior-most regulator, the Comptroller of the Currency himself onsite to emphasize these points, is going to have some effect. But we know that we are going to have to keep going back over and over and over again in order for this to really be meaningful.

Ms. MARGOLIES-MEZVINSKY. A couple of the companies that came to our small business roundtable say that they are too big to qualify for SBA loans and that they are too small to obtain the credit that they need from local banks. Will the proposals that you have outlined today help these companies to feel that they have some place to turn?

Mr. NEWMAN. Well, they should. I sure hope so. There is no reason why companies in that category should not be able to be provided credit by the private sector, by the banking system.

To the extent that we have put in place regulations that make it uneconomical for the lender and for the borrower to conduct business in that size range you are talking about, that is something we are addressing. The appraisal regulation is a very good example where, as we discussed before, just the sheer cost of doing an appraisal for a loan of that magnitude might have made it impractical, might have been such a large proportion of the loan size there was no way it made any sense for the borrower. That is the kind of thing that should make it viable and attractive for lenders to lend to businesses in that category.

Ms. MARGOLIES-MEZVINSKY. Finally, let me ask you a question that we felt permeated our meeting and that was that those we spoke to said that there was more of a threatening adversarial relationship between the Federal regulators and the business owners and the banks; that at no point did they feel that the Federal regulators could help them, or that there was a meeting of the minds. I don't know what we can do to change that, but perhaps in these sessions, after these training sessions that you are talking about, Congress could be the liaisons, the vessels to bring the regulators and business people together.

Mr. NEWMAN. Well, I agree, and that is a tough transition, because——

Chairman LAFALCE. I might point out that I don't recall in my tenure in Congress an Under Secretary for Domestic Finance having come out of the commercial lending field itself. So, that might make some big difference in what filters down to the examiners, the fact that he came out of the ranks of those individuals who felt they were being harassed by examiners. Have we had somebody as Under Secretary of Domestic Finance with your background in the past 12 years or so or even in the Carter era?

Mr. NEWMAN. Not to the best of my recollection, Mr. Chairman. I am not sure.

Chairman LAFALCE. No; it's always been somebody who really didn't know what it was like to be a lender.

Ms. MARGOLIES-MEZVINSKY. To be on the other side, yes.

Chairman LAFALCE. I didn't think you would mind if I threw that in.

Mr. NEWMAN. No; not at all, Mr. Chairman.

Actually, the transition going on for the examiners really is a tricky one. They have seen a lot of failures. Many of them have actually examined banks that had very poor practices and procedures. A number of them were situations where the written policies for making loans at a given institution looked perfectly fine, but when you went down to look at the loans actually made, they were in violation of the institution's own written policies. The procedures inside the institution for enforcing their own policies just were not being followed.

So, you deal with some examiners now who have gone through that very difficult time and genuinely believe that they have been taking actions that have helped to improve the safety and soundness of institutions, and through a very difficult economic time.

Now you say, OK, look, we have done a lot of that housecleaning. The economy is not robust but it is improving, and now more of the thrust, within the guidelines of safety and soundness, ought to be working with the bankers to help them constructively fulfill their roles in the economy, and that is literally what we have told people.

The Office of Thrift Supervision, which is again part of the Treasury, has literally held a meeting where it said exactly that to its examiners. Not that you can ignore safety and soundness, but more attention needs to be given to working constructively with the institution on serving the economy.

Ms. MARGOLIES-MEZVINSKY. So, not assuming everybody is the enemy.

Mr. NEWMAN. Exactly.

Ms. MARGOLIES-MEZVINSKY. Thank you, very much. Mr. Chairman, thank you.

Chairman LAFALCE. Mrs. Meyers.

Mrs. MEYERS. I would like to ask a question about the 20 percent of exempt loans or loans that can be made without documentation. I have been concerned that banks are moving some existing loans into that exempt category. Since these were loans that were made prior to that 20-percent exempted category, it seems like the banks would have decided that they were worth the trouble; that they could stand the scrutiny, and yet they are moving loans into that category rather than making new loans with that new authority.

What do you think about that, and have you seen some of that, and should banks be doing that?

Mr. NEWMAN. Well, I think it is too early to tell how widespread that is, and it will be something we will have to look at closely over the course of the next year or so. Because the policy statement has been out such a short period of time there have not been many completed examinations at those institutions. That was clearly not the intent.

If a bank has a particular reason for moving a loan into that category, I guess it is understandable, but clearly the intent was to create the environment for new lending, and if we find that the

program is being abused, we will address it, Congresswoman Meyers.

Mrs. MEYERS. Well, I would like to say that I really appreciated your testimony here this morning, and it has answered a lot of questions for me that I have gotten at home too. I think, clearly, your background has shown in your ability to not only answer questions but answer them in the kind of language that we can understand and then reinterpret. So, I appreciate it very much.

Chairman LAFALCE. The last question Mrs. Meyers asked is basically what I had brought up in my opening statement, and I don't know that we have adequately explored it.

We better start thinking of that before it happens rather than after it happens. How can we make sure we are talking about measuring new loans as opposed to a transfer? Otherwise, we can come in with some statistics which look good, but we will not have helped the economy, and we will not have helped create new jobs, and we will not have helped create new loans?

Mr. NEWMAN. I have it on my follow-up list here, Mr. Chairman.

Chairman LAFALCE. OK, good. What method do you have right now for tracking purposes? Forget for a second the transferring aspect, but what method did you have for tracking the results of the initiatives? Have you come up with something?

Mr. NEWMAN. Well, we have been debating that. I have not come to a conclusion yet. The reason is that it would be nice to collect a full set of data, but at the same time as we are trying to relieve burden on banks, we want to be cautious about asking them to fill out yet another form.

Chairman LAFALCE. Sure.

Mr. NEWMAN. It may be that we can collect enough information by sampling a set of banks nationwide without having every bank fill out a document, and we are still working on that question.

Chairman LAFALCE. OK. Give me a flavor for the type of documentation you have to fill out right now if you don't qualify for the minimal documentation program; the type of documentation you fill out if you qualify for the minimum documentation program?

Mr. NEWMAN. There are not any hard and fast rules, but typically, for a small business lender——

Chairman LAFALCE. Gene Ludwig came in and he said, these are the documents, and we are going to eliminate them down to here. But, what are we talking about substantively?

Mr. NEWMAN. Well, banks without this special basket that has been created might well feel, and their examiners might well feel, not only was a financial statement necessary but a projection over the next 3 to 5 years of an income and balance sheet was called for, a series of maybe 3 to 5 years' worth of tax returns, the appraisal on the facilities that are owned, perhaps——

Chairman LAFALCE. Is this small business lending you hope to spur now? Is it going to require less collateral than the old type of loan, or just less documentation?

Mr. NEWMAN. Less documentation.

Chairman LAFALCE. What did they mean when they said they wanted to get back to character lending? Character lending as opposed to what? Collateral lending? When are we talking about minimal documentation which requires the same collateral as

before, and when are we talking about character lending as opposed to what previously would have been collateral lending? Is that something other than this program?

Mr. NEWMAN. I see what you mean. The intent was that bankers would still make prudent judgments, even though the documentation requirements were less; that if collateral was taken, and the expression often used was in an abundance of caution, but it was not really part of the fundamental loan, then an appraisal would not necessarily be required.

Also, if the full documentation might have required, for example, this 3- to 5-year income and balance sheet projection, that if a business did not have such a fully developed projection and did not have auditors come in and sign off, et cetera, but the borrower was somebody who was known in the community, had a good record of responsibility in the community, then even though he might not have this kind of full business plan, the record of the individual as being responsible, being successful, and being known as a responsible person in the community might be sufficient for the banker to think that he was making a perfectly fine loan, and that is what would fall into this category.

Chairman LAFALCE. All right. The administration, after consultation with me, came in initially for $141 million for the first stimulus package. That would have leveraged $2.6 billion in loan guarantee authority. But then the way the money was being drawn down would have been inadequate to get to the end of this fiscal year.

So, after the Senate's frustrated consideration of the first stimulus package, we went back to the drawing board and the administration was very forthcoming and came in with $181 million, which we passed. It passed the House. That will provide $3.3 billion, not over the 4 years and not over the next fiscal year, but this fiscal year, between now and September 30, and every single dollar will be used.

I just say that to show the order of magnitude. Sometimes we get off into these other programs, such as the community development bank program, and this one is so much larger in scope and effect. There is absolutely no comparison.

So, the administration has been great, and they have been very helpful in working with the Senate too, even though we still have not met with success in the Senate. But the administration has also come in with some proposals that I am concerned about. They are going to cut back on the loan guarantee percentage. You are aware of that, are you not?

Mr. NEWMAN. Yes.

Chairman LAFALCE. I just don't know how that is going to cut. I mean, obviously, it is deficit driven. We can buy with a reduction in the guarantee percentage a lot more loan guarantees for a lot less subsidy money, but will the banks use it? How much is that going to impact? I don't know.

Then, second, we have been utilizing the secondary market for guaranteed loans tremendously. We want to develop a secondary market for nonguaranteed loans so we can get the Government out of the business or minimize the necessity of the Government being in the business.

But the administration—I don't know if you are aware of this—has called for a fee for secondary market utilization, and how much is that going to impact utilization of the secondary market? How much will the concurrence of those two run counter to what we are attempting to do in this program? Has Treasury looked into this? Is this something that just came out of SBA and went to OMB? Did OMB just a week or 2 days before submission of their budget say we have to come up with some additional dollars, so let's rehash some old recommendations. There are some old recommendations where we can save a little money and make the numbers work. Or did Treasury sit down and do a study on this?

Mr. NEWMAN. There has been no specific study in the sense of a survey of what the implications might be, and this is a proposal that was in place before I even arrived in Washington. I have in informal ways heard conflicting things from various bankers when I have talked with them about it. Some bankers say it will impede our lending; other bankers say it will not matter, we would rather have more ability to make a larger number of loans even if it is at a 75-percent average instead of an 82-percent average.

We are going to need some experience to see what happens, and maybe we need a more formal way of discussing through the implications before we get to next year's program, and we would be very happy to work with you on exactly that.

Chairman LAFALCE. I think you can use some help. I want to be cooperative, but I am fearful of what the consequences are going to be. Should we do both? Can we just do one rather than the other? Which one?

The small banks really like to sell off their paper; the big banks, for the most part, hold it, I believe. Did BofA hold its guaranteed paper?

Mr. NEWMAN. It was a mixture. It depended on their particular funding circumstances. It is clearly a trade-off. We are living in an environment, obviously, where we cannot afford to do everything we would like to do and some tradeoffs have to be made. I hope that this will turn out to be a trade-off that is successful and works. But if it does cause problems, if we do start to hear that there are problems, I agree with you, Mr. Chairman, we will need to come back, and I would be very happy to work with you on it.

Chairman LAFALCE. Then I hear of all these exotic programs being suggested—this, that and the other thing—and I wonder, hey, if you have a program that works, work with it. Don't cut back on it so that you can go off on to new, unchartered, and probably unsuccessful program—the enterprise zone proposals. I am all for the enterprise zone proposals when it comes to direct expenditures of moneys, but when you start giving special tax breaks based upon the location of a business, you have prostituted the tax code, and you have made it impossible to enforce, and you are just throwing money away.

Take that money and put it as a subsidy for loan guarantees. We could use it a lot in certain neighborhoods. We could use it much more effectively, much more effectively.

Well, those are my own thoughts.

Mr. NEWMAN. Again, Mr. Chairman, we would be very happy looking at ways in which the SBA Program might be utilized con-

structively not only to do what it has been doing successfully over the years but to perform other functions. We would be happy to work with you on that.

Chairman LaFalce. What is the status of the FFIEC report on statutory changes? Where are we?

Mr. Newman. Essentially, as I understand it, before this administration came into office, there was some comment made by some of the regulatory authorities that they had a target date. This, again, was my understanding. Not a statutory date but a target date of completing a study through this FFIEC, the five regulatory bodies, including the credit union administrator, on statutory issues, by the middle of this year.

When we came into office in this administration, one of the things we did, as I mentioned earlier, was to focus more attention on what we could get implemented fast that really made a difference in terms of the credit crunch alleviation initiative with these administrative and regulatory changes. So, our attention has been more focused in that direction, and the efforts that were noted with respect to the FFIEC have been put off. They have not been ignored, and they will not be ignored. It was just a matter of where to give priority.

Chairman LaFalce. During the 1989 debate, I opposed the creation of the RTC, saying we needed a RFC rather than a RTC; we needed to work to keep institutions open rather than spend every second of our time considering how we could close them down, although there were certain institutions that needed to be closed down. But I think we went at that, the administration and the Congress, with a vengeance. It became the be all and the end all, and regulators were brought in and asked how many institutions have you closed today? This was the yardstick of success.

I read that the OTS examiners were being rewarded for closing down institutions but that there has been a change in policy and now they are going to be rewarded if they can work with institutions and keep them open and bring them back to health. Do you know anything about this?

Mr. Newman. I can not speak to the prior policy, Mr. Chairman, but the current policy is very much to not jump prematurely. If, in fact, the authority does exist under the law, if an institution has a viable capital plan and a viable operating plan and can demonstrate that it has reasonable prospects of being successful, regardless of the technicalities, if you will, the OTS is trying to give them every opportunity to raise new capital, to be acquired, to establish a little bit of a track record of profitable operation, and is not jumping prematurely.

They are, at the same time, trying to keep the institution's feet to the fire in terms of raising capital. In other words, if it does look like there is an opportunity to raise capital, the OTS has been pushing pretty hard, saying to the institution, you really ought to be raising capital right now. But trying to give them every opportunity.

Chairman LaFalce. Some time ago, a month or two ago, I read in the American Banker that Bill Seidman said, the best thing you can do is not pass any more money for RTC, don't close down any more institutions for at least a year.

Did you read that? Did you ever have any conversations with Mr. Seidman? Do you have any insights that you could share with us on that? It was a very provocative statement. It sounded similar to what I had been saying in 1989, 1990, 1991, and 1992, but Mr. Seidman had been taking the exact opposite approach. I am not sure whether what I was saying then is applicable today as it was then. Maybe we just have to get it all behind us now. I was a bit surprised, though, when Mr. Seidman said it.

Mr. NEWMAN. Yes, Mr. Chairman; I did read that, and I did sit down and have lunch with Mr. Seidman, and we had a nice chat about a number of things.

Chairman LAFALCE. What can you tell us about it?

Mr. NEWMAN. He explained a bit more of what he had in mind, and there are some technical differences that really matter here. One thing he was pointing out, as was pointed out earlier, the lower interest rate environment has lowered the cost of the time clock, if you will. It has not eliminated it but has lowered it, and that is just a fact. There is also the possibility of borrowing from the——

Chairman LAFALCE. Using the assets the RTC has as collateral?

Mr. NEWMAN. Well, unfortunately, the assets are not sufficient to cover the obligations, so this would have to be unsecured borrowing, essentially. The problem is that the RTC already owes the Federal Financing Bank money. If the assets are not sufficient to repay, if it goes ahead and borrows more, and the assets are not sufficient to repay it, essentially the RTC will have borrowed money knowing full well it does not have the capacity to repay it, and that really requires an authorization of Congress. It is not proper for the RTC to go ahead and borrow money knowing full well it cannot repay it. That really does require an authorization of Congress.

The other thing that is a piece of this puzzle, that ultimately did get into the legislation in the House, as you know, since you were an important part of the process, is that there was a previous authorization already existing and just extending the date of that authorization with the RTC enables funds that had previously been authorized to be utilized now, and it looks like those funds from the prior authorization are sufficient to finish the job at the RTC. So, the current wording of the bill, instead of establishing a new authorization, just simply extends the date, and that is correct.

Chairman LAFALCE. I read somewhere in the past couple of days—in the Washington Post, Wall Street Journal, New York Times, American Banker—that GlenFed is doing something fairly unique in an attempt to raise capital. Are you familiar with that? Are they selling off their holding company? That has been a sticky wicket problem for years and years. Has there been some agreement between—whichever agency regulates them now? Is that OTS?

Mr. NEWMAN. Yes.

Chairman LAFALCE. That is under you, so——

Mr. NEWMAN. Mr. Chairman, I am not familiar enough with the details on that particular institution to comment now.

Chairman LAFALCE. I am not familiar enough with them to even pose the question the way I should. I just recall reading the article

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in the past couple of days. I thought it was rather unique. Any staff have anything on that? No? OK.

In your civilian life, in any event, you shared a lot of my thoughts about the need to modernize of our banking system. The administration has not, because they have so much on their plate, made recommendations as to how they think we can modernize it and, therefore, make our banking system more profitable and competitive domestically and in the global marketplace.

You know where I stand. I have written on it extensively. I have rendered a report as chairman of the task force on the international competitiveness of U.S. financial institutions. But of all of the issues, there seems to be growing support for repeal of interstate branching restrictions, with something attached. That is always the problem. What is that something attached?

It depends who you ask—if you ask the realtors, if you ask the insurance industry, the securities industry, et cetera. But because there has been so much political interest in the community development bank proposal, some people have floated the idea of taking whatever capital you could save through consolidation of your corporate structures that differ in each and every State and tossing that into a CD pot of money to leverage into private equity contributions.

Is that being discussed within the new administration—if you are going to consolidate and realize appreciable capital savings, you would take that money and dedicate it to the CD fund?

Mr. NEWMAN. Let me try to address the few issues you just raised, Mr. Chairman. First of all, I appreciate the fact that you shared with me the very thoughtful and I thought well-constructed letter you sent to President Clinton earlier on a number of these issues. I have been through it, and I am saving the letter to go through it again as we address some of these issues as time goes on.

With respect to the issue of interstate branching in general, particularly the ability to consolidate branches within an existing holding company structure, it is something that seems to me is worthy of very serious attention.

I come from California, as you know, which has never had any restrictions on branching. It is a very big State. It is an area which would encompass many smaller States, and there are close to 500 banks in California, roughly 20 of which are over a billion dollars in size. The vast majority of the banks are much smaller. There are, I think, literally hundreds of banks that are only in the $100 million or less size that are new community banks being chartered every year. It seems to be an environment in which both large banks and community banks thrive and do just fine. So, I am anxious to sort of extend what can be learned from the California experience and see how it might be applied more broadly.

I would certainly not want to propose to support something which would be unfair to community banks. On the other hand, I do have to question why banks that have multiple State operations, some of them actually are not necessarily large banks but they happen to be located on the border of a State line, why they should not be able to realize efficiencies because the efficiencies ultimately will lead to lower cost to the consumer, more capital accumulation

which can support more lending growth, and it is just good for the economy.

If it is good public policy, if we can find a way to do it that is appropriate, then it does not necessarily have to be linked with anything in a conceptual sense if it is good public policy on its own.

Chairman LaFalce. I agree with you, but we have had so many difficulties passing it over the years.

Mr. Newman. I understand that. I am aware, as you mentioned, that there has been a statement, particularly noteworthy, by the chairman of NationsBank about, gee, if only we could consolidate our branches, I would be happy to take some of the efficiency savings and put them specifically into community development bank activities.

Chairman LaFalce. By the way, that particular institution was extremely supportive of the concept of a GSE to facilitate the development of a secondary market.

Mr. Newman. OK. That is an issue if one crosses the bridge that you just mentioned as a practical matter, if there does need to be some linking, that is a perfectly reasonable proposal to consider and maybe worth some attention. The community development banking proposal has started out modestly.

Chairman LaFalce. Let's discuss that for a second. You talked about creating a community development corporation of sorts at the Federal level, that would then interface with other community development banks or lending entities, whatever they may have been, not necessarily banks. Is this corporation fleshed out in your mind? Would it be a GSE? Is it a Government-sponsored enterprise, this Federal corporation?

Mr. Newman. The way we envision it right now, and——

Chairman LaFalce. Because this would mean there is no doctrinaire approach on the part of this administration against GSE's. I am leading you to the next step.

Mr. Newman. I see, Mr. Chairman, and, as you know, the people at Treasury and other agencies are always very cautious about off balance sheet liabilities for the Government. It does not necessarily mean it is wrong, it is just a matter of caution.

The particular approach we envision——

Chairman LaFalce. Surely, it wasn't wrong with Fannie Mae or Freddie Mac. It stimulated the economy. As a matter of fact, you would not have had a housing market if it were not for those off-balance sheet liabilities.

Mr. Newman. I understand, Mr. Chairman, absolutely.

We are still working on the final details of the proposal to Congress on the community development banks. But the way we envision it now, the fund that would be established with Government money would not make any guarantees, would not immediately make any loans, and would not incur any other liabilities.

Chairman LaFalce. Right.

When you were at BOA, did you have responsibility for hedging exchange rates?

Mr. Newman. Excuse me, Mr. Chairman. I used the wrong expression when I talked about it would not guarantee anything nor would it borrow. It would not be a borrower.

Yes; I did. One of my areas of responsibility was interest rate risk management and hedging.

Chairman LAFALCE. Well, not just for interest rate risk but for exchange rate fluctuations?

Mr. NEWMAN. I actually did not have the traders reporting to me, but I had a group that was responsible for the policy and oversight of technical trading and hedging activities.

Chairman LAFALCE. OK. Well, putting on a small business hat and being cognizant of the instabilities that sometimes exist in the exchange rate market, I mean, if I am a small businessman, and I want to do business in Canada, I have to be pretty concerned about the value of the Canadian dollar and the value of the American dollar because if I make improvements to my store in Buffalo, New York or Niagara Falls, New York, on the basis that all of a sudden I am getting 1,000 Canadians' dollars a month that I didn't get before, I have to know if that is going to continue for the next year or two or three or whether it is subject to change tomorrow. It has been subject to change because we have witnessed a considerable decline, maybe 10 to 15 percent in the value of the Canadian dollar in the past year or so. But that is relatively small in comparison to the type of change you witness in other country's currencies.

Now let's go south of the border, Mexico. You see where I am leading you? In 1980, prior to the debt explosion, there were about 25 pesos to the dollar. Today, there are about 3,200 pesos to the dollar. Now, put your B of A hat on again and somebody comes to you, a small businessman, and wants to do business in Mexico or wants to open up a business in Texas or New Mexico to sell into Mexico.

What would you tell him he should be concerned about insofar as the fluctuation of the Mexican peso, vis-a-vis our dollar, in his business? If he invests in Mexico, builds a plant in Mexico, what will that do to his investment? Then, Mr. Newman, what lessons can we learn from that in fashioning this free trade agreement with Mexico if we don't have a supplemental agreement, as I am advocating, dealing with the subject of exchange rate coordination?

I think it is essential, especially with respect to a country which historically has had such exchange rate volatility, and no matter how much you can say things have changed, you never know.

We had unbelievable experiences in the Latin American countries and you cannot say it is changed permanently. You cannot say that. Even with a NAFTA, you cannot say that. So, what do you do in advance of that? What would you do as a banker to deal with that in advance? What would you do as a public policy official to deal with it in advance? I am asking you because you served there in the real world. I am asking some academics, but they have not been in the real world.

Mr. NEWMAN. That is an extraordinarily difficult question, as I am sure you know, Mr. Chairman.

Chairman LAFALCE. Have I hit on something important?

Mr. NEWMAN. Absolutely, and——

Chairman LAFALCE. I can't get anybody to be interested in this.

Mr. NEWMAN. Some of the examples you have cited are particularly difficult—the example of Buffalo and Canada. There are probably lots of banks on both sides of the border that are prepared to

provide a foreign exchange contract for known delivery in the future if somebody will be selling something and it will not be delivered for 6 months or buying something that will not be delivered for 6 months to provide a contract that will take the exchange rate risk out of that particular contract, and that is an important function banks provide.

Chairman LaFalce. That is one contract. That is not the operations of the business, though.

Mr. Newman. Right. The question you asked is a more difficult one; if you are planning an ongoing activity, and you have people coming across the border, and you do not know what the value of their currency might be. I do not have an answer, Mr. Chairman. There are people I think who may be much more knowledgeable about this.

As you know, we have an international Under Secretary, Larry Summers, at Treasury. He is very knowledgeable about these issues. We are supportive of NAFTA, as you know. We are supportive of——

Chairman LaFalce. I have to tell you, Mr. Newman, we don't have anybody on the American side who has been negotiating NAFTA who has given any thought to this issue. I think it is crucial.

Mr. Newman. I will pass the thought on to Larry Summers, Mr. Chairman.

Chairman LaFalce. OK, good. Think of what you would do as a banker if you were advising a businessman, especially a small businessman. If you are talking about a big business, if you are talking about a multinational, and, there is a big devaluation of the peso, it makes it easier for them to invest in Mexico.

Mr. Newman. Yes.

Chairman LaFalce. No question about it. One of the problems we have had, and I fault myself, too; I did not adequately perceive this. I was trying to get the dollar down against the yen from 1985 on, to the point that it got to be about 200 or 175. Then I started worrying that we were practicing a form of protectionism in beating the dollar down even further.

But then the biggest downside, and people don't realize it, is we have not had any U.S. investment in Japan because it is too expensive for U.S. corporations to go overseas and to invest in Japan and make inroads in that market.

Of course the exact opposite will be the case if there is a further devaluation of the Mexican peso. It will be an incentive not to do business in the United States but to establish the plants in Mexico. It would be an investment boom there.

None of the studies on job loss have even looked at the question of investment. They say investment is too speculative so we cannot look into what the investment changes will be, much less have they looked into the question of investment changes if, in fact, there is even further devaluation of the peso.

I just don't think we have done it very well. I think it is the type of thing that if you were in a bank you would want to look at those questions carefully and try to get the administration to be looking at them just as carefully as you would in the private sector.

Mr. NEWMAN. I will have a real conversation with Larry Summers, Mr. Chairman.

Chairman LAFALCE. It is time to vote, but I think this has been an extremely interesting hearing, and I thank you very much for coming.

Mr. NEWMAN. OK, thank you, Mr. Chairman.

[Whereupon, at 12:15 p.m., the committee was adjourned, subject to the call of the Chair.]

APPENDIX

OPENING STATEMENT OF THE HONORABLE JOHN J. LaFALCE, CHAIRMAN, HOUSE COMMITTEE ON SMALL BUSINESS

Hearing on the Administration's Credit Crunch Initiative
June 16, 1993

Today the Committee continues its longstanding inquiry into the credit crunch and the impact of the reduced flow of credit on small business.

For some time now, it has been clear that our banks have been reducing their level of lending and increasing their purchase of Treasury securities. This movement toward risk-free banking should have been easy to predict. The S&L crisis and subsequent problems in bank portfolios drove the Bush Administration and too many in the Congress to press banks to purge even the most prudent risks from their portfolios.

There have been signs that the economy in general is improving. But credit is still not flowing as it should. According to recent press reports, business loans, measured as a percentage of gross domestic product, are lower in this economic recovery than in any of the last five recoveries and have continued to decline sharply through the first quarter of this year. In fact, lending to U.S. businesses by U.S. banks declined by $68 billion, or nearly 14%, in the two years ending this March.

It is small firms -- who rely much more heavily on traditional lenders -- who always feel the brunt of such trends. Yet it is these same firms that are best able to catalyze the

economic growth and create the new jobs that this country so badly needs. Without the financial resources, it is impossible for them to play that role, and impossible for our economy to fully recover.

This Administration is to be congratulated for making the ending of the credit crunch one of its top priorities. On March 10, President Clinton announced a series of initiatives designed to increase small business lending. At that time, Administration spokespersons indicated we should start seeing some results in June. We meet today to see where we are and where we are going.

When the program was announced, Administration representatives indicated that as much as $46 billion in new lending could be expected to result from the credit crunch initiatives. Subsequently, in a hearing this Committee held with the regulators several weeks ago, Comptroller Ludwig again indicated that between $38 and $50 billion in new lending could be generated by the "low documentation loan basket" aspect of the President's program alone.

These projections are impressive, but I want to be certain they are real. Despite these optimistic forecasts, Committee Members continue to hear from borrowers -- and sometimes from bankers -- that nothing is really changing. In particular, I remain concerned that loans already on bank books will simply be re-classified into the newly-created basket.

I understand that it is difficult to determine exactly what, if any, changes in lending patterns might be traceable to the regulatory revisions that have been made, particularly given

historical problems in the reporting of small business lending. But we must have a concrete means by which to assess the impact of this important initiative. I would hope Under Secretary Newman would tell us more today about how the Administration expects to monitor and assess the results of its program.

This is particularly critical given the relationship the Administration appears to see between its credit crunch program and other programs designed to encourage small business lending. For example, President Clinton has himself indicated that some of the restrictions being proposed for the SBA loan guarantee program in fiscal 1994 would be offset by new lending resulting from the credit crunch initiative. Before we make any dramatic changes in the loan guarantee program -- which has been a critical safety valve during the credit crunch -- we must have a good sense of what results we can reasonably expect from the credit crunch initiative.

The Committee also wishes to know what other initiatives of this nature the Administration plans to embrace. The regulators have been working on defining what, if any, statutory changes are essential if we are to put the credit crunch behind us. Their recommendations are expected shortly. We would hope Under Secretary Newman will enlighten us as to the status of that effort and indicate what priority the Administration will attach to legislative changes on this issue.

I would like to be able to say the credit crunch problem is behind us, but we have little evidence that it is. Only last week, Members of the New England delegation met with the

regulators to inquire why banks still did not seem to be back in the business of lending. One very real problem is that some of the restrictions on lending that have been lifted, have been lifted only for the most highly capitalized institutions. Yet the areas of our country which continue to suffer the most, such as New England and California, contain few such institutions. Some believe we may need to extend the benefits of the credit crunch initiative to undercapitalized institutions that are improving. I would appreciate your comments, Under Secretary Newman, as to whether that would be advisable, and whether legislative changes in existing banking law, such as the prompt corrective action provisions of FDICIA, would be necessary to do that.

We are very appreciative of your taking the time to be with us today, Under Secretary Newman, to share your perspective on these important issues.

STATEMENT OF
U.S. REP. JAN MEYERS
RANKING MINORITY MEMBER
COMMITTEE ON SMALL BUSINESS

HEARING ON CREDIT AVAILABILITY

JUNE 16, 1993

Thank you Mr. Chairman, and thank you Under Secretary Newman for appearing before the Committee today.

I appreciate this opportunity to hear what progress the Administration is making in its efforts to improve credit availability for this nation's small businesses.

Late this past April, Eugene Ludwig, the Comptroller of the Currency, testified before this Committee along with representatives of the FDIC and the Office of Thrift Supervision. During the course of Mr. Ludwig's testimony, he pointed to a stack of federal banking regulations which measured over fifteen inches in height and stated that, "It is our goal to reduce this stack of regulations to about three inches." This, of course, was good news to me and to many other Members of this Committee, not to mention the millions of small businesses who are presently suffering from the lack of needed capital. So, Mr. Newman, if you could tell us that stack of regulations is shrinking and will continue to shrink, you will make me and many others quite happy.

One of the things I would like you to address today in your testimony Mr. Newman is something beyond the present "credit crunch", something I like to refer to as a "capital crunch", which is a larger issue which I believe this Administration should recognize and begin to address. Many of this nation's small businesses could grow and prosper and create more jobs if they could get the infusion of capital they need to expand. Now, Chairman LaFalce and this Committee have, for the most part, focused on improving the ability of small firms to grow by getting needed loans from financial institutions. If you could, Mr. Newman, I would like you to also address how we can make it easier for small businesses to get needed capital from other sources, primarily investors, and how we can better attract risk taking investors to invest in small businesses. An obvious suggestion would be better tax treatment for capital gains, but I'm sure with your accomplished background in the private sector you can probably help us with many good ideas.

I look forward to your testimony.

OPENING REMARKS OF THE HON. GLENN POSHARD
COMMITTEE ON SMALL BUSINESSES
JUNE 16, 1993

Mr. Chairman and members of the Committee, I am pleased to be here this morning to hear testimony about the administration's program to enhance credit availability.

The credit crunch and its impact of reducing the flow of credit to small businesses is one of the most important economic issues facing our country today. We all agree that small businesses provide the bulk of new jobs in the country. My district stretches over 220 miles from north to south encompassing mid-sized cities with other areas predominantly rural in nature. I applaud the Federal Reserve Board's actions to maintain low rates which makes refinancing mortgages and first-time home-buying easier but still has not given the needed stimulus to small businesses. I look forward to hearing from our witness, Undersecretary of the Treasury Newman, about this most important issue.

Thank you Mr. Chairman.

OPENING STATEMENT OF CONGRESSMAN BILL ZELIFF (R-NH)

Small Business Committee

June 16, 1993

Mr. Chairman, thank you for calling today's hearing about the Administration's credit crunch initiatives. I want to welcome Under Secretary Newman to this hearing.

I have been to many hearings about the credit crunch. They have all been informative and have brought forth many good ideas. However, it is time to start solving the problems behind the credit crunch.

The credit crunch and government over-regulation continue to be major concerns for small businesses.

We are here today to discuss the Administration's new initiatives to resolve this credit crunch and the impact of the program on the small business community.

The Administration recently offered guidelines character lending. Character lending has a good premise but I have not seen any positive results from it in my home state of New Hampshire. It seems as if we are only working around the fringes of the problem and not getting to the roots and coming up with a solution.

I hope today's testimony will provide some insight on how the Administration will get some results in solving the lack of credit problem and promote job creation. So we can put our people back to work. Thank you.

STATEMENT FOR
CONGRESSMAN FLOYD H. FLAKE
BEFORE THE COMMITTEE ON SMALL BUSINESS
JUNE 16, 1993

GOOD MORNING MR. CHAIRMAN AND MEMBERS OF THE SMALL BUSINESS COMMITTEE. I WELCOME OUR WITNESS, UNDERSECRETARY FOR DOMESTIC FINANCE, MR. FRANK NEWMAN, AND THANK HIM FOR THE TESTIMONY HE WILL PROVIDE.

MR. CHAIRMAN, I AM VERY CONCERNED ABOUT THE IMPACT OF THE CREDIT CRUNCH ON SMALL BUSINESSES AS THIS CRISIS PERSISTS. THE 7 (a) LOAN PROGRAM EXHAUSTED ITS LOAN GUARANTEE AUTHORITY ON APRIL 7, 1993 AND MANY BUSINESSES CONTINUE TO SUFFER AS A RESULT. IN NEW YORK ALONE, OVER $37 MILLION HAS BEEN GUARANTEED THROUGH THE SBA, HOWEVER, UNTIL THESE FUNDS ARE AUTHORIZED, SMALL BUSINESSES REMAIN AT A STANDSTILL.

WE ARE ALL AWARE OF THE SIGNIFICANT ROLE THAT SMALL BUSINESSES PLAY IN SPURRING GROWTH AND OPPORTUNITY. THE QUESTION IS, HOW CAN WE MAKE AN EARNEST EFFORT AT RESOLVING THIS DILEMMA IN SOME TIMELY AND EFFECTIVE MANNER? AS WE HAVE REVISITED THIS ISSUE ON A FEW OCCASIONS, IT IS MY HOPE THAT FRANK NEWMAN, THE UNDERSECRETARY FOR DOMESTIC FINANCE, CAN SHED SOME LIGHT ON THE ADMINISTRATION'S INITIATIVE TO STRENGTHEN ACCESS TO CREDIT.

AS AN ADVOCATE OF COMMUNITY DEVELOPMENT, I AM INTERESTED IN THE PERSPECTIVE OF OUR WITNESS RELATING TO THE ROLE OF COMMUNITY DEVELOPMENT INSTITUTIONS IN ALLEVIATING THE LACK OF CREDIT AVAILABILITY TO SMALL BUSINESSES. IN ORDER TO REINVIGORATE SUFFERING COMMUNITIES AND FALTERING BUSINESSES, IT IS OBVIOUS THAT WE MUST EXPAND BUSINESS OPPORTUNITIES FOR ALL COMMUNITIES. THEREFORE, AS WE PENETRATE THIS MATTER, I HAVE AN EARNEST CONCERN

ABOUT ADDRESSING COMMUNITY NEEDS THROUGHOUT THIS PROCESS.

THE SMALL BUSINESS COMMUNITY IN MY DISTRICT IS APPROPRIATELY CONCERNED ABOUT HOW THIS IMPASSE WILL BE RESOLVED. WITH THAT IN MIND, I LOOK FORWARD TO HAVING MR. FRANK NEWMAN, UNDERSECRETARY FOR DOMESTIC FINANCE, BEFORE THE COMMITTEE THIS MORNING.

STATEMENT BY CONGRESSMAN JIM RAMSTAD
BEFORE THE HOUSE SMALL BUSINESS COMMITTEE
June 16, 1993

HEARING ON PRESIDENT CLINTON'S EFFORT
TO EXPAND CREDIT AVAILABILITY FOR SMALL BUSINESSES

Mr. Chairman, I welcome the opportunity to discuss the critical issue of credit availability for small businesses with the Under Secretary for Domestic Finance Mr. Frank Newman.

As a member of both the Small Business and Joint Economic Committees, I am keenly aware of the importance of small businesses to our economy -- and the problems they have faced in recent years in gaining access to credit.

The effect of tight credit is particularly hard on small businesses, which, unlike larger companies, do not have easy access to the debt and equity markets. Because they have no alternative financing avenue, when small businesses face tight credit, the result is devastating to the entire economy.

Small businesses, as we all know, are the real engine of job growth in our economy. In recent years, 85% of all new jobs in this country were created by small businesses, and in fact between 1988 and 1990, small businesses created all of the net new jobs in this country, according to the Small Business Administration (SBA).

Now that President Clinton continues his attempt to impose the largest tax increase in history, the availability of credit for small businesses will be an even more urgent concern. As most economists agree, President Clinton's proposal to transfer $328 billion from the productive, private sector to the federal government will certainly constrict economic growth and reduce the availability of capital.

At a time of economic sluggishness, it is clear that enacting the largest tax increase in American history will have dire consequences for the jobs-producing, small business sector of our economy.

I trust that today's distinguished witness will provide specific and substantive insights into how President Clinton's regulatory relief proposals -- which appear to me to be only a needed first step toward the regulatory relief we need -- will ease the burden on our banks and small businesses and address the resulting credit crunch.

SMALL BUSINESS FULL COMMITTEE

OPENING STATEMENT OF CONGRESSMAN SAM JOHNSON

CREDIT CRUNCH HEARING

JUNE 16, 1993

THANK YOU MR. CHAIRMAN.

I WANT TO THANK YOU FOR HOLDING THIS HEARING TO EXPLORE THE CREDIT CRUNCH AND ITS EFFECT ON SMALL BUSINESS. WE ALL KNOW THAT SMALL BUSINESS IS THE JOB-CREATING ENGINE OF THE UNITED STATES. HOWEVER, DUE TO BURDENSOME REGULATIONS AND SCARCE CREDIT OPPORTUNITIES, OUR SMALL BUSINESSES ARE QUICKLY RUNNING OUT OF GAS.

ALTHOUGH THE NEED <u>CLEARLY</u> EXISTS FOR START-UP CAPITAL, THE ADMINISTRATION'S TEMPTATION TO CAPITALIZE NEW FEDERAL COMMUNITY DEVELOPMENT BANKS SHOULD BE RESISTED. INSTEAD OF FOCUSING ON BUREAUCRATIC SOLUTIONS TO THE CREDIT CRUNCH, THE PRESIDENT SHOULD CONSIDER THE MARKET-BASED ALTERNATIVES RIGHT UNDER HIS NOSE. WHY NOT OFFER <u>INCENTIVES</u> TO SECONDARY INSTITUTIONS, BANKS, AND THRIFTS TO MEET THE FINANCIAL NEEDS OF SMALL BUSINESSES AND OTHER CHARACTER LOANS.

I AM OPTIMISTIC ABOUT THE ADMINISTRATION'S PLEDGE TO IMPROVE CREDIT AVAILABILITY BY ELIMINATING DUPLICATIVE EXAMINATION PROCEDURES AND REDUCING LOAN DOCUMENTATION. HOWEVER, I SINCERELY HOPE ALL VIABLE ALTERNATIVES, ESPECIALLY THOSE INVOLVING THE PRIVATE SECTOR, WILL BE EXAMINED. I LOOK FORWARD TO THE TESTIMONY OF MR. NEWMAN.

The Administration's Credit Availability Program and Other Efforts to Promote Small Business Growth

Testimony Before the

House Committee on Small Business

Frank N. Newman

Under Secretary for Domestic Finance

June 16, 1993

Statement of the Honorable Frank N. Newman
Under Secretary for Domestic Finance
United States Department of the Treasury
before the
Committee on Small Business
U.S. House of Representatives

June 16, 1993

Mr. Chairman and members of the Committee, I appreciate this opportunity to discuss with you the Administration's efforts to improve credit availability and to promote the growth and vitality of small businesses. Many of you have encouraged this effort, and we believe the Program will be constructive for months and years to come.

As you are all aware, the United States has spent over two years in a very slow economic recovery. A recovery from a recession characterized, in part, by high corporate, public, and personal indebtedness. All business activity is subdued in this type of economic environment. Individuals reducing their personal indebtedness and concerned about keeping their jobs, do not spend much. Businesses, unable to generate strong sales growth and reducing their debt levels, do not seek much new credit from financial institutions. They tend to focus on raising new equity in the stock market or elsewhere to help improve their debt-to-equity ratios.

The banking and thrift industries, a crucial source of business credit, mirror all these financial cross-currents. They are experiencing reduced demand for credit from businesses that do not need to borrow to sell to consumers who are reluctant to buy. In addition, the financial services industry has been recovering from lending excesses of the 1980s, including an abundance of poor credits that resulted in major loan losses. For many industries the recession was relatively mild, but for depository institutions it was one of the worst downturns in recent American history. Hundreds of banks and thrifts failed in the last five years and hundreds more suffered extensive loan losses. Banks and thrifts, like individuals and businesses, have been reducing problem loans, reducing debt, and building equity.

The slow recovery has been particularly difficult for small- and medium-sized businesses. Many of them tend not to have the financial strength and staying power of large multi-market and multi-product organizations. As a result they do not have access to as many sources of financing. Many small businesses lack a sufficient credit history to get credit from any but those few lenders that have helped them since they began operations. It is especially difficult for small- and medium-sized businesses to obtain equity financing.

The new Administration is committed to do everything possible, consistent with sound economic policy, to stimulate

economic activity and to create more jobs. Since small- and medium-sized businesses are major job creators, we are giving these businesses special attention. In addition, small- and medium-sized businesses often depend more than large companies on commercial banks for credit, and they have indicated that the availability of bank credit is unusually meager in this recovery. Furthermore, many analysts and lenders have identified regulatory impediments as a constraint on credit availability.

For these reasons, the Administration has committed itself to increasing the availability of credit within the economy generally and to small businesses in particular. This commitment has taken the form of an Administration Credit Availability Program and a Cabinet-level Task Force on New and Growing Businesses. The remainder of my statement will outline the goals and achievements of these two initiatives.

I. The President's Credit Availability Program

On March 10, President Clinton announced a program of regulatory and administrative changes to improve the availability of credit, particularly to small- and medium-sized businesses, farms, and low-income and minority borrowers and communities. Since then, the federal bank and thrift regulators have been meeting at least weekly to discuss the initiatives and to resolve

any problems. Moreover, we have made a special effort to coordinate the regulatory programs of the four agencies.

I am pleased to report to the Committee that nearly all of the proposed regulatory changes have been implemented. A status report on all of the proposed changes is attached to my statement. At this time, I would like to take a few minutes to discuss some of the more important items and then to highlight our progress on those items still to be completed.

Program Progress

As of our target date of June 10, the federal bank and thrift regulators completed the initial phase of the President's Credit Availability Program. To alleviate the apparent reluctance by banks and thrifts to lend, we focused on the following five regulatory areas.

First, the agencies took steps to eliminate impediments to lending to small- and medium-sized businesses. As you all are aware, small businesses often rely heavily on commercial banks as a source of funds for operating capital and expansion. To address this issue, the agencies on March 30 released an Interagency Policy Statement on the Documentation of Loans. Under this policy statement, the strongest banks and thrifts can make and carry some loans to small- and medium-sized businesses

and farms with only minimal documentation. The total of such loans at an institution will be limited to an amount equal to 20 percent of its total capital.

In addition, the agencies have clarified the examination and rating procedures relating to the Special Mention category of loans so that such loans are not improperly grouped with classified loans. Currently, bank examiners place weak loans into one of three classification categories. The categories are substandard, doubtful, and loss. Loans that are classified generally have the potential for loss, or the loss has occurred. These loans are carefully reviewed and examiners often require the bank to set aside additional capital or reserves to back loans in these categories. Loans that are not classified, but may have potential weaknesses that bank management should address, are often placed in the Special Mention Asset category. Small business loans are frequently placed in this category because they involve judgement, which is very subjective.

In the past, the federal banking agencies and thrift agencies used different terminologies and definitions for the Special Mention Asset category. Often, examiners grouped Special Mention Assets and classified assets into a category called "criticized assets." By using the total of criticized assets, as opposed to classified assets, the examiner put too much emphasis on Special Mention Assets in judging the quality of the bank's

assets. This treatment makes a serious difference when it is noted that, historically, within two years of classification, net charge-offs have averaged some 50 percent of loans classified as doubtful, 10-20 percent of loans classified as substandard, but only one to five percent of loans designated as Special Mention. This illustrates just how harshly small business loans have been evaluated in this context.

The agencies have thus adopted an Interagency Statement to ensure that Special Mention assets are not grouped with classified assets. This action should address the concern that the mis-categorization of loans has hindered small business lending.

Second, the agencies took steps to reduce the burden of real estate appraisals and to improve the climate for real estate lending. On June 4, the agencies published, in the Federal Register, a proposed rule that would increase to $250,000 the threshold level at or below which certified or licensed appraisals are not required. In addition, the proposed rule would expand and clarify existing exemptions to the appraisal requirement, identify additional circumstances when appraisals are not mandated, and amend existing rules governing appraisal content and appraiser independence. The Administration is concerned that in some cases, appraisals may prove so expensive

that they make a sound small- or medium-sized business loan uneconomical.

On May 5, the OCC published a proposed rule that revises its Other Real Estate Owned, or OREO, regulation, which generally concerns foreclosed property. The proposed changes will: (1) increase and expand the options that a national bank may use to dispose of OREO, (2) standardize the legal and accounting treatment of OREO, and (3) provide flexibility in the financing of OREO. This proposed rule will help banks move OREO off their balance sheets and into the hands of investors seeking to improve the property.

The agencies have also issued an Interagency Policy Statement on the Review and Classification of Commercial Real Estate Loans. The statement reaffirms guidelines issued in November 1991 to provide clear and comprehensive guidance to ensure examiners review commercial real estate loans in a consistent manner. Further, the agencies have offered additional guidance with respect to in-substance foreclosures and returning nonaccrual loans to accrual status. Guidance in both areas are consistent with generally accepted accounting principles (GAAP).

Third, the agencies have taken steps to improve the fairness and effectiveness of their appeals processes. In particular, each agency will ensure that it provides a fair and speedy review

of examination complaints. The OCC has created a new Ombudsman position to manage its appeals process. The Ombudsman, who reports solely and directly to the Comptroller, has the ability to supersede any agency decision or action during the resolution of the appeal. The OCC's appeals process will require that appeals are resolved in a fair, expeditious manner.

Fourth, the agencies are working to eliminate duplicative examination processes and procedures. They have announced an agreement to better coordinate examinations and to streamline the examination of multibank holding companies.

Fifth, the OCC has begun using new procedures to detect discrimination in residential lending by national banks to ensure that credit is made available broadly and fairly. In addition to revised examination procedures, the OCC will develop a pilot program to use minority and non-minority "testers" to identify discrimination in the way banks treat potential borrowers. In short, this Administration will not tolerate lending discrimination.

Future Steps

Some of the regulatory changes will take a longer time to implement. As the attached list indicates, these longer-term items include a review of paperwork, corporate applications, and

documentation requirements. These tasks involve a fine tuning of existing requirements, which must be carried out carefully so as not to exacerbate the problem. The OCC has also committed to rewrite and reorganize its regulations to make them clear and accessible. As a former banker, I can tell you that this will be a major task.

One of the most difficult tasks we face is changing the very cautious culture that pervades the regulatory agencies. We had a long recession that caused many problems for financial institutions. The regulatory agencies, down to the examiner level, worked hard to minimize every risk they could, often urging bankers to be as conservative as possible. Now the recession is over, and bankers must get back to prudent risk-taking in support of economic growth. Examiners must also adjust to the new period of economic expansion, and they must be comfortable that their supervisors will not reprimand them for being more balanced, while still promoting safety and soundness.

To achieve this objective, we have developed these rules which are clear enough for everyone to understand what is expected. In addition, there will be training sessions and meetings for examiners with senior officials to explain the Credit Availability Program. The Comptroller has already begun a series of meetings with examiners in each of his Office's

districts. This intensive effort to communicate with everyone about the new Program should speed its full implementation.

As with any proposal, its ultimate success depends on how well it achieves its objectives. The regulatory changes we have adopted should enable banks and thrifts to increase credit availability. However, as I stated earlier, many factors affect the aggregate lending pattern of depository institutions.

We have focused at the outset on regulatory and administrative changes because these can be implemented in short order, thereby freeing up much-needed credit as quickly as possible, consistent with safety and soundness. As we move beyond the implementation stage, we will focus more closely on legislative proposals to improve the availability of credit. At the same time, we will continue to review the regulatory framework within which banks operate to identify any additional burdens that must be addressed. We very much consider this Program an ongoing and cyclical one.

II. Other Efforts to Promote Small Business Growth

I would like to turn now to some of the other Administration efforts to promote small business growth. For example, the President's National Economic Council has established an interagency working group on New and Growing Businesses to be co-

chaired by the Department of Commerce and the Small Business Administration. The Working Group will examine regulatory burden, lending, capital delivery, technology, export promotion, and other issues with a particular emphasis on the nexus between these issues and job creation, innovation, and economic growth.

Within the Group, Treasury staff have been examining proposals to promote small business growth, from the simple and well-understood to the more theoretical. For example, one simple method of providing credit to the small business community is through the Small Business Administration's Section 7(a) Program, which guarantees bank loans to small businesses. Without the guarantees these borrowers would not be able to obtain credit under the same terms and conditions. Funding the 7(a) Program was part of the Administration's economic stimulus package and a program that I am pleased to note has the strong support of Chairman LaFalce and other members of the Committee. As a result of that bill's demise, a program that is widely supported and is annually refunded has suddenly came to a halt. Refunding the Section 7(a) program could get funds to small businesses quickly. The banking industry strongly supports the program and can start making new loans as soon as the guarantees become available.

Some of the more innovative proposals would facilitate investment in small business organizations by investment companies, enhance the development of a secondary market for

securitized small business loans, and create a government sponsored enterprise for small business loans (as proposed by Chairman LaFalce). Each of these proposals recognizes the benefits provided by the secondary markets we already have for residential mortgages, school loans, credit card receivables, auto loans, and so forth, and seeks to obtain the same benefits through a secondary market for small business loans.

We support the efforts of Chairman LaFalce and others to examine methods of promoting small business growth. We have been and will continue to work with Congress to craft legislation that best serves the needs of both borrowers and lenders.

III. Conclusion

Enhancing the provision of credit to small- and medium-sized businesses is a difficult task. We have already made some progress by implementing the President's Credit Availability Program. We will continue to look at additional potential methods of improving credit availability to foster economic growth.

I will be pleased to answer any questions the Committee may have.

Attachment: Status of the Administration's Credit Availability Program

Completed Regulatory Changes	Type of Action	Agencies Involved	Status
Announcement of the Credit Availability Program: On March 10, President Clinton announced the program.	Interagency Policy Statement	OCC, OTS, FDIC, FRB	Completed 3/10/93
Documentation of Loans: This action eliminates unnecessary documentation requirements for small- and medium-sized business and farm loans.	Interagency Policy Statement	OCC, OTS, FDIC, FRB	Completed 3/30/93
Special Mention Assets: The agencies have clarified their examination procedures to insure that special mention assets are not improperly placed in the classified asset category.	Interagency Policy Statement	OCC, OTS, FDIC, FRB	Completed 6/10/93
Real Estate Appraisals: The action would increase to $250,000 the threshold level at or below which appraisals are not required.	Proposed Rule	OCC, OTS, FDIC, FRB	Published in the Federal Register 6/4/93
Other Real Estate Owned (OREO): The initiative will: (1) increase and expand the options that a national bank may use to dispose of OREO, (2) standardize the legal and accounting treatment of OREO, and (3) provide flexibility in the financing of OREO.	Proposed Rule	OCC	Published in the Federal Register 5/5/93
Commercial Real Estate Loans: The statement reaffirms guidelines issued in November 1991 to provide clear and comprehensive guidance to ensure examiners review commercial real estate loans in a consistent manner.	Interagency Policy Statement	OCC, OTS, FDIC, FRB	Completed 6/10/93
In-Substance Foreclosures: The agencies have offered additional guidance with respect to reporting of in-substance foreclosures.	Interagency Policy Statement	OCC, OTS, FDIC, FRB	Completed 6/10/93
Returning Nonaccrual Loans to Accrual Status: The agencies have revised the accounting for partially charged-off loans consistent with generally accepted accounting principles (GAAP).	Interagency Policy Statement	OCC, OTS, FDIC, FRB	Completed 6/10/93

Completed Regulatory Changes	Type of Action	Agencies Involved	Status
Appeals Process: The agencies have taken steps to ensure that their appeals processes are fair and effective.	Agency Program	OCC, OTS, FDIC, FRB	The OCC announced the creation of an Ombudsman on 6/10/93
Fair Lending Initiatives: The agencies will strengthen their enforcement of fair lending laws by revising discrimination detection methods and revising their consumer complaint systems. In addition to revised examination procedures, the OCC will develop a pilot program to use minority and non-minority "testers" to identify discrimination in the way banks treat potential borrowers.	Interagency Policy Statement	OCC, OTS, FDIC, FRB	Completed 6/10/93
Examination Coordination: The agencies are working to eliminate duplicative examination processes and procedures. The agencies have announced an agreement to better coordinate examinations and to streamline the examination of multibank holding companies.	Interagency Agreement	OCC, OTS, FDIC, FRB	Completed 6/10/93
Future Steps			
Excess Paperwork Burden: Each agency is individually performing a study of its paperwork, corporate application, and documentation requirements.	Agency Program	OCC, OTS, FDIC, FRB	To be announced at a later date
Regulatory Review: The OCC has committed to rewrite and reorganize its regulations to make them clear and accessible.	Agency Program	OCC	To be announced at a later date
Effectiveness Measurement: The OCC is devising methods to measure the effectiveness of the Credit Availability Program. For example, it plans to document whether banks are taking advantage of the provisions of the Interagency Policy Statement on Documentation for Loans.	Agency Program	OCC	To be announced at a later date

Joint Release

Office of the Comptroller of the Currency
Federal Deposit Insurance Corporation
Federal Reserve Board
Office of Thrift Supervision

For immediate release

Federal Regulators Announce Additional Credit Availability Initiatives

June 10, 1993

The four federal regulators of banks and thrifts today announced six additional initiatives to implement the President's March 10 program to improve the availability of credit to businesses and individuals. These initiatives include changes to regulatory reporting requirements and the issuance of joint policy statements on the valuation of real estate collateral, use of the "Special Mention" category in reviewing loans, and improved coordination of examinations. The changes to regulatory reporting requirements are consistent with generally accepted accounting principles (GAAP).

The agencies noted that these latest actions bring to a close the first phase of the President's credit availability program. However, all four agencies emphasized that they are continuing efforts to reduce the paperwork and regulatory burden that impedes the flow of funds to creditworthy borrowers.

The actions announced today cover these areas:

- **In-Substance Foreclosures**

  In the past, the agencies' rules required certain loans to be reported as in-substance foreclosures. In the revised guidance issued today, the agencies make it clear that a collateral dependent real estate loan need not be reported as foreclosed real estate unless the lender has taken possession of the collateral. However, appropriate losses must be recognized. This guidance is consistent with the approach taken by the Financial Accounting Standards Board (FASB) in its new standard on loan impairment.

- **Returning Nonaccrual Loans to Accrual Status**

  In the past, a loan that was partially charged off could not be returned to accrual status until all missed payments had been made up to bring the loan to current status and the institution expected to receive the full contractual principal and interest on the loan.

(more)

This reporting requirement also applied in situations where the borrower showed a renewed ability and willingness to service the remaining debt. Accordingly, institutions sometimes found it difficult to work with borrowers who were experiencing temporary difficulties in a way that would maximize recovery on these troubled loans.

To address this problem, the agencies are making two revisions to their nonaccrual guidelines. First, banks and thrifts will be allowed to formally restructure troubled debt in a manner that will allow a portion of the debt to become an accruing asset, provided certain criteria are met. This revised reporting guidance makes the policies of the bank and thrift regulatory agencies consistent.

Second, in some cases, borrowers have resumed paying the full amount of scheduled contractual principal and interest payments on loans that are past due and in nonaccrual status. Under the guidance issued today, banks and thrifts will be allowed to return such past due loans to accrual status, provided the institution expects to collect all principal and interest due and the borrower has made regular payments in accordance with the terms of the loan over a specific period of time.

- **Regulatory Reporting Requirements for Sales of Other Real Estate Owned (OREO)**

The agencies will separately issue guidance to banks and thrifts that generally conforms regulatory reporting requirements for sales of OREO with generally accepted accounting principles (GAAP), as set forth in FASB Statement No. 66. These changes delete certain requirements for minimum down payments for sales of OREO. Financial institutions and examiners should refer to FASB Statement No. 66 for a detailed discussion of the accounting principles that apply to sales of real estate.

- **Review and Classification of Commercial Real Estate Loans**

The agencies are reaffirming their guidelines issued in November 1991 to ensure that examiners are reviewing commercial real estate loans in a consistent, prudent and balanced manner. Today's policy statement reiterates that the evaluation of commercial real estate loans is based on a review of the borrower's willingness and capacity to repay and on the income-producing capacity of the underlying collateral over time. The statement emphasized that it is NOT regulatory policy to value collateral that underlies real estate loans on a liquidation basis.

(more)

- **Supervisory Definition of Special Mention Assets**

  The agencies are concerned that improper use of the "Special Mention" loan category in examiners' reviews of loan portfolios may inhibit lending to small- and medium-size businesses. Accordingly, all four agencies have adopted a uniform definition for this category.

  The use of a common definition will lead to more consistent supervision among the four agencies. It will also enable examiners to more readily segregate Special Mention assets from those warranting adverse classification. The agencies have agreed to use classified assets, which by definition do not include Special Mention assets, as the standard measure in expressing the quality of a bank or thrift's asset portfolio.

- **Coordination of Holding Company, Thrift and Bank Examinations**

  The four agencies are issuing interagency guidelines to coordinate their supervision and examinations in order to minimize the disruptions and burdens associated with the examination process. Under the principles laid out in the guidelines, the agencies will work to eliminate duplication in examinations by multiple agencies. Examinations and inspections of a particular legal entity will be conducted by the primary supervisor for that entity. The agencies will increase coordination of examinations and will establish procedures to centralize and streamline examinations in multibank organizations.

The initiatives announced today follow a number of actions previously taken by the four agencies to implement the President's credit availability program. Those actions include:

- **Interagency Policy Statement on Documentation of Loans** (March 30, 1993)
- **Interagency Letter on Lending Discrimination** (May 27, 1993)
- **Proposed Rule on Revised Appraisal Requirements** (June 4, 1993)
- **Interagency Release on Joint Fair Lending Initiatives** (June 10, 1993)

The four agencies emphasized that they will continue their efforts to reduce paperwork and regulatory burdens and improve the ability of small businesses and consumers to gain access to credit. For example, in the coming months, the agencies expect to modify their procedures for corporate applications (e.g., applications for charters, mergers, and branches) to make them less duplicative and more uniform.

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NR 93-64

Joint Release

Office of the Comptroller of the Currency
Federal Deposit Insurance Corporation
Federal Reserve Board
Office of Thrift Supervision

For immediate release

Interagency Policy Statement on Fair Lending Initiatives

June 10, 1993

The four financial institution regulatory agencies are announcing initiatives that they will pursue over the next several months to enhance their ability to detect lending discrimination, to improve the level of education they provide to the industry and to their examiners, and to strengthen fair lending enforcement.

Background

A number of interagency efforts are already completed or are under way to improve fair lending detection techniques, enforcement, and education. For example:

- The agencies have issued a joint statement to financial institutions that reaffirms their commitment to the enforcement of the fair lending laws and provides the industry with guidance and suggestions on fair lending matters.

- The agencies are working on a revised supervisory enforcement policy for dealing with violations of the Equal Credit Opportunity and Fair Housing Acts. This revised policy will replace a policy issued in 1981. The revised policy specifies corrective actions for several different substantive violations of the ECOA and FHA.

- The agencies are developing uniform fair lending examination procedures and training programs. The agencies believe these new procedures will significantly strengthen existing discrimination detection programs. These new examination procedures will be publicly available this summer.

New Initiatives

The four agencies will pursue the following new initiatives over the next several months:

(more)

1. **Fair Lending Training for Examiners**

   The agencies will develop a new training program in fair lending for experienced compliance examiners that will be conducted on a regional basis. A pilot program could be held as early as Fall 1993.

2. **Fair Lending Seminar for Industry Executives**

   The agencies will develop and sponsor regional fair lending programs for top level industry executives (chief executive officers and executive vice presidents) to explain their efforts to enforce fair lending laws and to foster additional sensitivity and awareness among lenders about discrimination issues, specifically subtle practices that impede the availability of credit to low-income and minority individuals. The first session of this program could be held later this year.

3. **Alternative Discrimination Detection Methods**

   The agencies will explore statistically-based discrimination analysis models. These models may help identify loan applications files for review as part of the examination process. This will significantly enhance the agencies' abilities to identify loan applicants that may have received differential treatment.

4. **Stronger Enforcement of Fair Lending Laws**

   Each agency will implement an internal process for making referrals to the Department of Justice for violations of the Equal Credit Opportunity Act. These internal procedures will ensure that appropriate cases are being put forth for consideration by senior management.

5. **Improved Consumer Complaint Programs**

   The agencies believe that refinements to their consumer complaint systems can also better promote the broad availability of credit on a non-discriminatory basis. During the next few months, each agency will evaluate the effectiveness of its consumer complaint system in detecting and correcting credit discrimination, and alerting the agencies to industry practices that may inhibit the free flow of credit. Each agency will announce its own specific initiatives in these areas.

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NR 93-55

Joint News Release

Federal Reserve Board
Comptroller of the Currency
Office of Thrift Supervision
Federal Deposit Insurance Corporation

For immediate release May 27, 1993

To address the concern that some minority consumers and small business owners are experiencing discrimination by lenders, federal bank and thrift supervisors today reiterated their commitment to effective enforcement of fair lending laws and urged bank and thrift institutions to increase their fair lending activities.

In a letter to all banks and thrifts, the heads of the four agencies said that discrimination strikes at a basic tenet of a free market system: equal opportunity for all to gain access to bank services. The letter said the regulators expect all financial institutions to do their part to design programs to ensure access to credit on a non-discriminatory basis.

The letter urged special attention to 11 specific fair lending activities, including enhanced employee training, internal second review programs for loan applications that might otherwise be denied, participation on multi-lender mortgage review boards, and affirmative marketing and call programs.

A copy of the letter and the suggested fair lending activities is attached.

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Attachments

May 27, 1993

TO THE CHIEF EXECUTIVE OFFICER:

The federal financial institutions supervisory agencies are deeply concerned that some minority consumers and small business owners may be experiencing discriminatory treatment in their efforts to obtain credit from financial institutions. Discrimination in lending, on any prohibited basis, strikes at the fabric of both our political commitment to equal opportunity and our economic commitment to free and competitive markets.

Our agencies are committed to making sure that financial institutions understand their fair lending obligations and respond appropriately. We will continue to strengthen and refine our fair lending enforcement activities. Examiners will routinely use HMDA data, as well as other information, to identify cases which require closer examination. Examiners will then conduct detailed reviews and comparisons of loan and application files to examine for compliance with fair lending laws and regulations. The agencies will continue to develop and refine computer-based programs to facilitate and improve this process. This is part of an ongoing effort to develop tools that will further help examiners and institutions analyze HMDA data, review examination procedures and determine how they can be strengthened to detect and deter discrimination in lending.

In cases where examination results or other information suggest probable fair lending violations, we will cooperate with the U.S. Department of Justice and the Department of Housing and Urban Development.

We further believe that a sustained national effort to expand and intensify educational programs for both lenders and consumers is necessary, with an emphasis on greater sensitivity to fair lending issues. We urge financial institutions to use their maximum creativity to design appropriate programs. We especially urge consideration of the ideas listed on the appended sheet.

It is clear to the agencies that more needs to be done to assure equal access to credit by everyone in our country. We expect all financial institutions to participate in this effort.

Alan Greenspan, Chairman
Board of Governors of the
Federal Reserve System

Andrew C. Hove, Jr.
Acting Chairman
Federal Deposit Insurance Corporation

Jonathan L. Fiechter
Acting Director
Office of Thrift Supervision

Eugene A. Ludwig
Comptroller of the Currency
Office of the Comptroller
of the Currency

SUGGESTED FAIR LENDING ACTIVITIES

- Use of an internal second review system for consumer, mortgage and small business loan applications that would otherwise be denied.

- Enhanced employee training that engenders greater sensitivity by financial institution management, and employees, to racial and cultural differences in our society.

- Training of loan application processors to assure that any assistance provided to applicants ir how to best qualify for credit is provided consistently to all loan applicants.

- Efforts to ensure that all persons inquiring about credit are provided equivalent information and encouragement.

- Use of flexible underwriting and appraisal standards that preserve safety and soundness criteria while responding to special factors in low- and moderate-income and minority communities.

- Efforts to encourage equal employment opportunity at all levels throughout the institution, including lending, credit review, platform and other key positions related to credit applications and decisions.

- Affirmative marketing and call programs designed to assure minority consumers, realtors, and business owners that credit is available on an equitable basis; marketing may involve sustained advertising programs covering publications and electronic media that are targeted t minority audiences.

- Ongoing outreach programs that provide the institution with useful information about the minority community, its resources, credit needs and business opportunities.

- Participation on multi-lender Mortgage Review Boards which provide second reviews of applications rejected by participating lenders.

- Participation in public or private subsidy or guarantee programs that would provide financin on an affordable basis in targeted neighborhoods and communities.

- Use of commissions or other monetary or nonmonetary incentives for loan officers to seek and make safe and sound consumer and small business loans in minority communities.

Joint Release

Office of the Comptroller of the Currency
Federal Deposit Insurance Corporation
Federal Reserve Board
Office of Thrift Supervision

May 26, 1993

Federal Agencies Propose New Rule on Real Estate Appraisals

The Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve Board, and the Office of Thrift Supervision (OTS) today issued a joint proposed rule to amend their regulations on real estate appraisals.

The agencies said the proposal would reduce regulatory burden by requiring appraisals only when they enhance the safety and soundness of financial institutions or otherwise further public policy. The proposed rule would:

- Increase the threshold level for required appraisals from $100,000 to $250.000;
- Expand and clarify existing exemptions to appraisal requirements; and
- Identify additional circumstances when appraisals are not required.

The agencies are proposing these amendments based on their experience in implementing their current appraisal regulations. The proposed rule would limit direct and indirect costs of real estate appraisals to borrowers, costs that the agencies said can restrict the availability of credit.

For example, business loans under $1 million secured by real estate would not require appraisals when real estate collateral is not the primary source of repayment. The proposal also expands an existing exemption for transactions where real estate is taken as collateral through "an abundance of caution." These changes will help small- and medium-sized businesses obtain credit, the agencies said.

The proposed rule exempts from the agencies' real estate appraisal requirements transactions that are insured or guaranteed by a U.S. government agency or government sponsored agency.

(more)

The proposal also clarifies existing exemptions in the current regulation. The clarifications involve transactions not secured by real estate, transactions related to renewals of existing loans and the extension of additional credit on those loans, and transactions involving purchase of loans or interests in pools of loans secured by real estate.

Finally, the proposed rule reduces the number of minimum standards for the performance of real estate appraisals. It reinstates the Departure Provision that allows an appraiser to prepare an appraisal without complying with certain provisions of the Uniform Standards of Professional Appraisal Practice (USPAP), provided the appraisal report is not misleading. The proposal also clarifies the circumstances in which a bank or thrift may use appraisals prepared for another financial services institution.

The proposed rule will be published for public comment in the Federal Register. The agencies are particularly seeking comments on loss history for real estate transactions that involved appraisals, the effect of the proposed regulation on credit availability, and the cost and time spent complying with the existing regulation.

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DEPARTMENT OF THE TREASURY
WASHINGTON

UNDER SECRETARY

October 19, 1993

The Honorable John J. LaFalce
Chairman
Committee on Small Business
U.S. House of Representatives
Washington, DC 20515-6315

Dear Mr. ~~Chairman~~: John —

Thank you for inviting me to testify before the Small Business Committee on the Administration's efforts to improve credit availability. I have enclosed for your review a reply to the questions that we did not have the opportunity to cover at the hearing. Please accept my sincerest apologies for the delay in responding to your questions.

If you would like to discuss any of these matters further, please let me know. Thanks again for inviting me to testify, and I look forward to working with you and the other members of the Committee.

Sincerely,

Frank

Frank N. Newman
Under Secretary of the Treasury
Domestic Finance

Enclosure

ANSWERS TO QUESTIONS FROM CHAIRMAN JOHN J. LAFALCE

Q1. Special Mention Asset Category (Page 25)

Are there any major banks that do have sophisticated computer systems, such as Bank of America or Citicorp, or something where we could get some handle on what percentage of non-guaranteed small business loans almost automatically are being tossed into that (Special Mention Asset) category?

A1. There is no one generally accepted computer system presently in use in the banking industry that tracks small business loans. Also, although we did not canvas every major bank, our staff does not know of any bank that segregates its loans in such a manner. In general, small business loans are evaluated on their credit quality and repayment capacity in the same manner as other loans and not automatically placed in the special mention asset classification category.

Q2. Special Mention Asset Category at Closed Institutions (Page 26)

It might be interesting to take a look at those institutions that have been closed to see how the examiners treated that classification of loans at that time. It may be informative.

A2. Special mention assets are not a significant determinant in failure situations. Loans that are classified substandard or doubtful, which are more severe classifications, account for at least 100 percent of capital and usually range from 300 percent to 400 of capital in problem banks. While banks and regulators still identify assets as special mention if appropriate, a bank's reserve level is driven by specific allocations on doubtful and certain substandard assets, as well as allocations against pools of substandard loans and write-downs of other real estate owned (OREO) property. Reserves against special mention assets are usually only one-tenth to one-fourth the amount of normal reserves for substandard loans.

Q3. Proposed Rule on Real Estate Appraisals (Page 27-28)

Could you flesh that out (the effect of real estate appraisal requirements on bank failures) in writing for this Committee?

A3. The OCC, FDIC, Federal Reserve Board and OTS seriously considered that question prior to proposing revisions to their Real Estate Appraisals regulations. In the preamble to that interagency Notice of Proposed Rulemaking, found at 58 Federal Register 31878 (June 4, 1993), the federal financial institution regulatory agencies discussed the "historical studies" mentioned by Under Secretary Newman in his testimony before the Small Business Committee of the House of Representatives.

In the preamble, the federal banking agencies made the following findings:

The agencies believe that an increase in the threshold level from $100,000 to $250,000 for banks and thrifts would not represent a threat to the safety and soundness of financial institutions. Moreover, the agencies believe that federal financial and public policy interests would continue to be protected if the proposed increase was adopted.

The agencies believe that the majority of loans below a $250,000 threshold level would continue to be loans secured by one-to-four family residential real estate. Thus, the agencies do not believe loans of $100,000 to $250,000 would pose significantly greater risks to financial institutions than similar loans below the existing threshold. The agencies believe that in the event such losses do occur, the $250,000 threshold would protect the deposit insurance funds and the safety and soundness of financial institutions.

Q4. The North American Free Trade Agreement (NAFTA) and Exchange Rate Coordination (Page 83)

Mr. Newman, what lessons can we learn from that (peso devaluation) in fashioning this free trade agreement with Mexico if we don't have a supplemental agreement, as I am advocating, dealing with the subject of exchange rate consultation coordination?

A4. The issue of currency exchange rates is clearly important to the economic well-being of the nation and the flow of international trade. I understand your concern that Mexico and Canada might attempt to undermine the benefits of NAFTA by manipulating their currencies to seek an unfair advantage. However, the Treasury does not believe that a side agreement on exchange rates is necessary.

Neither Mexico nor Canada has a history of using competitive devaluations in order to achieve trade advantages. Mexico, on the contrary, has traditionally sought to maintain stable exchange rates as a foundation for price stability and sustainable economic growth and has generally resisted pressures for devaluation, sometimes at great cost. NAFTA, by bolstering investor confidence in Mexico, should help to encourage capital inflows needed to finance imports (largely from the United States) and support the peso.

By creating an environment in which goods, services, and capital moves more freely, NAFTA should increase the prospects for non-inflationary growth in the U.S. and Mexican economies and thus also for a more stable exchange rate for our currencies. Indeed, anticipation of the NAFTA has been a significant factor in encouraging the emergence of a positive U.S. trade balance with Mexico while also helping to slow the depreciation of the peso.

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